

What the Attorney Needs to Know About Life Settlements Amidst the COVID-19 Pandemic

By Henry Montag, CFP

Ever since the U.S. Supreme Court case of *Grigsby v. Russell* established a life insurance policy as “private property,” the ownership rights in a life insurance policy have been placed on the same legal footing as a typical investment property, such as stocks and bonds, or a person’s home or auto.¹ As such, a life insurance policy could be transferred to another person at the discretion of the policy owner.

The life settlement market, primarily funded by hedge funds and often referred to as the secondary market, has greatly enhanced the consumer value of life insurance planning and has become a significant alternative to merely surrendering a life insurance policy that is either no longer needed, wanted, or one that can no longer be afforded. The life settlement market has significantly enhanced the consumer liquidity value of life insurance planning and management involving senior and impaired risk insured persons. This is of particular interest to many clients today, who are dealing with the harsh economic realities of the current COVID-19 Pandemic.

Life Settlement Market History

The settlement market evolved in the late 1980s with the AIDS outbreak, when terminally ill individuals were liquidating assets to generate cash. Given the sellers’ shortened life expectancy, investors were purchasing policies for an amount in excess of the policy cash value and expecting an attractive return from payment of the death benefit. Subsequently, the market expanded to include older as well as impaired-risk insured persons. Until the 2008-09 financial markets crisis, settlement practices were questionable, causing a number of states to regulate this market for consumer protection purposes.

Who Is Eligible for a Life Settlement?

While a life settlement can be entered into by anyone owning a life insurance policy, only those policies that have a face value of at least \$100,000, with an insured who is at least 70 years old and in poor health, are likely to have a life settlement broker accept and turn in an application to a funding source that is likely to provide the insured an offer. In an attempt to prevent fraud and elder abuse, it is not sufficient to merely have a life insurance license in order to conduct a life settlement transaction. A life insurance agent is required to complete a separate background application and have his or her fingerprints registered by the FBI. Further, license process has clearly defined the fiduciary role of the broker representing the seller, and how this role should be documented to safeguard the interests of all parties.

The problem is that the majority of clients, and many of their advisors, are not familiar with the concept of a life settlement. If a decision is made to no longer maintain their coverage, they either surrender the policy back to the life insurance company that initially issued the policy, or they merely stop paying the billed premium and, by virtue of default, they use up the accumulated cash surrender value until the cash value is no longer sufficient to pay the premium required to maintain the policy’s coverage.

There are several reasons for this lack of knowledge regarding the usage of a “life settlement.” Perhaps one of the most significant is the fact that insurance companies much prefer that a person, regardless of their reason for not continuing their coverage, either exercise their option to surrender their policy back to the insurer, or merely discontinue paying their billed premium. Either option translates into the insurance company keeping all of the past years’ paid premium while never having to pay out a death claim.

Court Filings Lack of Transparency and Disclosure

Since a life settlement transaction keeps a life insurance policy in force rather than allowing it to be surrendered or lapsed, many life insurance companies employing a “career agency” have forbidden their life agent field force to discuss this concept. This is because the transaction takes away a percentage of the insurer’s built-in profits when a typical number of policies lapse or are surrendered for their cash value each year. This concept of “active concealment” of the life settlement option, according to an article in *Think Advisor*, “is pervasive amongst

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He has appeared as a guest on Wall Street Week, Fox Business News and News 12. He’s provided CPE and CLE continuing education credits to NYSBA, ABA, AICPA, NYSSCPA and the estate Planning Council. He co-authored an American Bar Association flagship publication titled, “*The Life Insurance Policy Crisis: The Advisors’ and Trustees’ Guide to Managing Risks and Avoiding a Client Crisis*” (Jan 2017). The Jan 2019 issue of *Commerce Clearing House* referred to him as “one of today’s best brains in life insurance.”

life insurance carriers because surrendered and lapsed policies are key sources of profitability.” (“California couple sues Lincoln National,” May 5, 2014).

One such “gag order” that prevented an agent from advising the client to consider a life settlement resulted in a class action lawsuit, *Larry Grille v. Lincoln National Life Ins.* in a U.S District court filing in Riverside County California.² The case involved Larry Grille, age 82, the insured, his wife Joan, the beneficiary, and son Steven, acting as trustee. The insured could no longer afford to pay the premium on his \$7.2 million life insurance policy so they set up a meeting with their life insurance agent and his manager at the Lincoln National Life Insurance Company. The beneficiaries explained that they could no longer afford to pay their premium and requested the agent’s advice as to available options. The agent’s and his manager’s solution was to reduce the death benefit from \$7.2 million to \$2 million without any mention of the possibility of selling the policy on the secondary marketplace as a life settlement. After the transaction was completed the son realized that they could have sold the \$5.2 million, that they had just given up, for a substantial sum of money in the secondary marketplace. They obtained counsel and proceeded to sue Lincoln National Life Insurance Company for “failure to disclose the life settlement option.” The court filings went on to include allegations of fraud, elder abuse and unfair and fraudulent business practices. The point of the story is not the legal outcome, rather the fact that insurers are not forthcoming when it comes to allowing their agents to disclose the life settlement option since they do not feel that they have a fiduciary obligation to do so.

Another reason for the lack of discussion centers around the fact that many individuals, including their advisors, confuse a life settlement with STOLI, Stranger Owned Life Insurance. This is where an individual agent or broker induces an insured to purchase a life insurance policy for the sole purpose of selling it for a profit within a few years of purchasing it. Such an arrangement is illegal, but a life settlement is not. Clients need to be aware that an individual has the ability and right to sell a no longer needed or a too expensive life insurance policy, just like they would a home, a car or any other personal property.

Consumers and their advisors must be made aware of the fact that one’s death benefit should never be reduced or surrendered without first exploring the benefits of a life settlement option, or some form of a life sale with a retained interest. A life settlement, depending on a client’s age and health, can provide an insured with a significantly higher payout than the insured would receive if they merely surrender the policy for its cash value.

Why Is the Settlement Market Important to Seniors?

Legal and tax advisors play a critical role in alerting their clients to the availability of the secondary market. This article is intended to provide them with an over-

view of the settlement market and information the seller should know before undertaking a policy sale. The single most important decision in considering a settlement is selecting an independent, experienced settlement broker who has access to established providers, is familiar with their respective purchase criteria and preferences, and understands the negotiating process necessary to prudently represent the client’s best interests. The lapsing policy and insurance trust insolvency crisis begs the obvious question from legal and tax advisors—what do you do when an older client inquires about the possibility of restructuring an existing problematic policy and/or selling it?

Tens of thousands of American seniors annually lapse or surrender their life insurance policies to the insurance companies. Americans ages 65 and older forfeit \$143 billion of life insurance coverage annually by lapsing or surrendering their life insurance policies, according to research unveiled at the Life Insurance Settlement Association’s (LISA) Fifth Annual Institutional Investor Life Settlement conference (latest figures as of 2015). A survey of seniors conducted by ICR Custom Market Research found that 55% of respondents allowed their life insurance policies to lapse; and further, 82% of the respondents were not aware that alternatives like a life settlement existed. In that same study 79% of clients felt advisors should inform them about a life settlement strategy. A study conducted by the Insurance Studies Institute (ISI) found that 90% of seniors who lapsed a life insurance policy would have considered a life settlement had they been aware of the possibility.

Payment Options Available to Seller

Life settlement payment options can take the form of cash, a retained death benefit interest, or a combination of cash and retained death benefit interest. The offer amount usually depends on life expectancy of the insured, as measured by no less than two life expectancy reports from credentialed third-party firms, plus the opinion of the provider’s internal medical staff. A cash offer is less complicated and, therefore, the most frequently requested offer form. A retained interest offer amount can be more favorable to the seller because the buyer has no upfront cash outlay and the seller is paid from participation in the death benefit proceeds. However, a retained death benefit interest offer imposes additional risks and tax considerations that require thoughtful discussion with the seller’s legal and tax advisors as well as documentation review.

As an example, a recent case I just completed involved a male aged 72 with a \$750,000 policy and a \$275,000 loan that accrued over the years as a result of the insured realizing that after the fifth year, he could maintain the policy without making a premium payment in the sixth year. Once he had the experience of not making a premium payment and still maintaining the majority of the policy’s death benefit, he decided to forgo making a premium payment in the sixth-22nd year. It was at that point, the 23rd year, that he was referred to me to see if

anything could be done to provide him relief from the \$275,000 loan he had accumulated. Without the means to pay back the principal or the interest or to pay the premium, he faced having the policy lapse while he was still alive. This not only meant he would have lost the death benefit but also he would have been liable to pay the tax on the gain over and above the premium he paid.

Fortunately a buyer was obtained that was willing to take over the obligation to pay off the loan and continue to pay the premium, thereby absolving the seller from a significant tax bill that he would have been responsible to pay despite the fact that he was only left with an unpaid loan rather than a lump sum of money. While the seller received virtually no cash in exchange for the policy, he was relieved of the potential tax liability and received a retained death benefit for a number of years, which made him and his family very happy.

Similar situations as a result of the current pandemic have left many a business owner in situations where they either can no longer afford to pay the premiums, or they need to sell their policy in order to raise some much-needed cash to pay for other essential needs.

A Word About Taxes

The tax basis for a life settlement is based on premiums paid into the policy. Any cash surrender value in excess of the basis is taxed as ordinary income. Any value received above the cash surrender value is taxed as a long-term capital gain. For example:

Premiums paid	\$100,000
Cash Surrender Value	\$110,000
As a result	\$10,000 is subject to Ordinary Income
Value of life settlement	\$200,000
As a result	\$90,000 is subject to Long-Term Capital Gain

What the Experts Have to Say

Stephen Shorrock, President of Veris Settlement Partners, who advises attorneys and CPAs regarding life settlements, responded as follows when asked by me his opinion about the current state of affairs regarding the pandemic. "Life settlements will show significant growth as an exit strategy to help clients fill the hole from lost wages, business losses and market declines. The supply of dollars to buy life settlements far outweighs the supply of policies to be sold. Now is a good time to review your client's life insurance portfolio to see if a life settlement solves some of the damage created by the pandemic. As the life settlement market continues to evolve, more money sources are entering the market with non-traditional buy boxes. Historically, the life settlement market has focused on older, less healthy insureds owning traditional universal life policies. Today, however, policies

that provide little or no cash surrender value, but provide a guaranteed death benefit, are being settled."

Steven M. Schanker, Esq., partner in Schanker and Hochberg P.C., a N.Y. estate planning firm, had this to say.

When I first entered this field of estate planning in 1979, the Federal exemption was rising to \$175,000 over a 5-year span. Forty-one years ago almost every client had an estate tax problem and their assets were mostly illiquid. The client's choices were gifting and giving up control or life insurance. The decision was obvious when your clients are type A entrepreneurs. Now, with a vastly increased exemption most clients have no estate tax due. The permanent insurance they purchased is no longer needed and they rush to surrender. I am contacted frequently by clients asking what happens if their policy is surrendered and the proceeds go into the ILIT. When I recommend they explore a life settlement the uniform response is they never heard of it and they are surprised their life insurance agent nor company ever told them about it.

In Conclusion

The secondary market provides a better exit strategy for clients who find their life Insurance policy no longer affordable, no longer needed for estate tax purposes, or is perhaps required for a more immediate cash need today. While the responsibility of managing a life policy rests with the owner of an insured's life insurance policy, keep in mind that 90% of such owners are the sons, daughters and friends of the insured acting as unskilled or accommodation trustees. The other 10% acting as professional trustees are fully aware of their client's options. Be aware that some life insurance agents, whom one would expect to discuss this strategy with their clients are also registered representatives with their insurance company's sponsored broker dealer. As such they may have restrictions on their ability to discuss a life settlement transaction with their client.

So, rather than having your client merely surrender their life insurance policy back to the Insurance company simply because it's more convenient, or because they're not aware of any other alternative, consider educating your client to the benefits of retaining an independent experienced licensed life settlement brokers—professionals who contractually affirms their fiduciary duty to the seller and assists your client and their trustee in obtaining the best possible offer to the insured, or to their trust estate. In either case they, and or their family, will thank you.

Endnotes

1. 222 U.S. 149 (1911).
2. *Larry Grille et al v. Lincoln National Life Insurance Company* (5:14-cv-00051) California Central District Court, Filed 01/09/2014.