



**INTEGRITY**

Life Settlements, L.L.C.

# **An Introduction to Life Settlements**

*Presented by:*

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## What is a “Life Settlement” ?

- **Definition** – the purchase and sale of a life insurance policy on a senior for an amount greater than the cash surrender value.
- Typically age 70 and above. a.k.a. “senior settlement” .
- Institutional secondary market (contra private investor).
- Purchaser (Investor) becomes new owner and beneficiary of the policy; responsible for all subsequent premium payments.
- Current owner receives a lump–sum payment of cash (to use as he likes).
- Insured remains the insured as long as the policy is in force, which is likely until his death.

## Requirements and Parameters

- Ages
  - 65 with significant health issues
  - 70 and above generally
  - really about Life Expectancy (2 – 12 years)
  - Viatical Settlements (< 2 years LE) distinguished
  
- Policy types – investment must last through death of insured.
  - So, all policy types except: Non-Convertible Term
  - UL and convertible term work best.
  - VUL, IUL, Whole Life, Survivorship also fit but are more difficult.
  
- Face amounts
  - \$250,000 and above generally
  - \$100–250,000 – simplified apps
  
- Carriers – B+ rated or better

# Conceptual Framework

1. I don't need it...  
I don't want it....  
I can't afford it!
  - a. Plain vanilla – personal, family and trusts
  - b. Key–Person (corporate–owned)
  - c. Charity

or
2. Policy Replacement – more on this later (time permitting).  
I can afford it...and  
I want and need life insurance  
(e.g. for estate or financial planning  
or wealth preservation)  
*“Arbitrage” in context of Life Settlements*

## Understanding the Process

- 1 a. **Plain Vanilla type**  
I don't need it...  
I don't want it....  
I can't afford it!

Simple Case Example to take us  
through the process



## Understanding the Process

### Our client, Mr. Smith

- Age 78 – reasonable health.
- Grantor of his family trust – an ILIT.
- Trust owns \$2 million face – UL life ins. policy.
- Annual target premium \$70,000.
- Policy issued 5 years ago.
- Cash surrender value = \$50,000



## Understanding the Process

### Case example

#### Change in Circumstances

- Client lost 50% of his wealth in the market
- And his income has diminished significantly
  
- Cannot afford to make premium payments
- Does not need the policy for estate planning
- Does not want the policy anymore



## Understanding the Process

### Options prior to existence of a Life Settlement?

- Tender the policy back to carrier for CSV
- Lapse it.

### Now – a Life Settlement Option

- Truly an “option” – an investigation up until the point of signing the documents
- Even then, often a 15 day rescission period
- No out-of-pocket costs to the seller. Costs borne by Broker and all compensation is earned only upon a successful sale and paid from buyers funds.



# Understanding the Process According to the role of each player

## The Agent or Advisor's role.

- Recognize the opportunity for Mr. Smith.
- Understand and explain the concepts of L.S.
- If appropriate and Mr. Smith agrees, refer the case to a reputable life settlement broker.
- Why a broker?
  - Fiduciary obligations to your client – maximize price
  - Detail oriented and lengthy process
- Work with and guide client throughout process in coordination with the broker.



## Understanding the Process

### The life settlement broker's role

1. Life settlement application
  - Information on client and policy
  - Release medical records – HIPAA
  - Release Policy information
  - Disclosures
2. Collect medical Records (btw, no exam required)
3. Conduct (outsourced) medical evaluation = LE report
4. Obtain policy information, illustrations, etc.

# Understanding the Process

## The life settlement broker's role (cont. )

5. Submit all information to possible Buyers
  - How many buyers? 20–40
  - Who are these buyers?

*Let's digress some and talk about the "Buyers"*

### PROVIDERS vs. FUNDERS

- ❖ Providers role – fiduciaries to Funders
- ❖ Counterpart to Broker
- ❖ Pricing decisions? Policy housing and servicing.
- ❖ Legal compliance.
- ❖ Providers distinguished from Funders
- ❖ Motivations – IRR (Internal Rate of Return) – buy low
- ❖ Funders In the news lately...e.g. securitization?



## Understanding the Process

### **The life settlement broker's role (cont. #2)**

6. Solicitation of bids, negotiation = informal auction.
7. Consultation with Advisor/client.
8. Acceptance (or not) of best offer.
9. Receipt of Provider's closing documents.
10. Review documents, markup for completion and signature by client.
11. Assist Advisor to help client through closing.

## Understanding the Process

### Some comments on the life settlements closing

- Closing documents all similar
- Components
  - Purchase and sale agreement
  - Escrow agreement
  - Attachments including designation of contacts
  - Limited power of attorney (travelling)
- Importance of escrow versus language “show me the money”.



## Understanding the Process

### Back to our client...Mr. Smith

- Documents signed; escrow funded.
- Acc/ to documents, purchase price to Mr. Smith.
  - **\$240,000** (12% of face)
  - **vs.**
  - CSV of **\$50,000**
  - Arbitrary example – but typical
  - 4 to 6 multiple of CSV
- Now what? Smith: *“Where’s my money?” how much longer....*

## Understanding the Process



### Timing involved with a life settlement

2 – 3 weeks for medical, LE and policy information

+

4 – 8 weeks working with Buyers, negotiation and execution of documents

6 – 11 weeks so far

+

2 – 4 weeks more for change of ownership/beneficiaries

8 – 15 weeks

#### **Recap:**

8 weeks = a miracle

12 weeks = an average?

Each case varies

Some as long as 6 months – don't hold your breath

## Brief History: Viaticals to Life Settlements and our problems “growing up”

- The 1980s – the **HIV-AIDS crisis**
  - Successful protocols – the “cocktails”
  - Unexpected longevity
  
- **Problems on the investment side**
  - Mutual benefits = tainted industry
  - securitization analogies' to real estate mess
  - ponzi schemes using life settlement as front
  
- **STOLI...**
  - “Say buddy, can I interest you in \$150,000 for your insurability?”

### Bottom line?

- A less than stellar reputation.
- But distinguish:
  - sales side from investment side
  - True life settlements from STOLI

## There ought to be a law

- There are laws in most states. (41? + CA = 42?, + NY=43?)
- More laws developing – variation on model acts.
  - NCOIL or NAIC models
  - Trend – anti STOLI but pro-consumer/L.S.

## Legal highlights – very generally

- Licensing required to do the business
  - Providers
  - Brokers
- Situs rules apply
  - e.g. cannot move a trust for purposes of a life settlement out of the situs state
- Required information disclosures and/or state brochures
- Disclosure of compensation to clients sometimes required

## Tax Implications

Disclaimer – this is issue spotting only – we are not tax experts.

- Prior to August 26, 2009 changes:
  - Sale of an asset
  - Sales price – basis = gain.
  - No gain = no tax.
  - To extent gain < cash surrender value = ordinary income
  - To extent gain > cash surrender value = capital gain.
  - Basis = premiums paid.
  
- IRS revenue ruling effective Aug. 26, 2009
  - Basis = premiums less C.O.I. (cost of insurance!!)
  
- Example today:

➤ Sales Price		\$ 200,000
➤ CSV		\$ 30,000
➤ Premiums paid		\$ 60,000 in total for all years
➤ <u>COI</u>		<u>\$ 35,000 in total for all years</u>
➤ Gain = 200 – (60 – 35) =		\$ 175,000
➤ Ordinary income =		\$ 30,000
➤ Capital gains =		\$ 145,000

## Reasons to settle a policy – what to look for?

### ➤ Generally speaking...a change in circumstances

Remember conceptual framework..

(1. Don't want it, don't need it, can't afford it. )

#### 1a. Personal – family changes

- Beneficiaries pre-deceased grantor/insured.
- Other \$ needs more pressing:
  - LTC, medical bills, living expenses, retirement needs.
- Loss of a job or other income.
- Loss of net worth – as in case example
- End of term in a term life policy with conversion feature

## 1b. Reason for Purchase of Key-Person Insurance

(not-exhaustive)

- ▶ **Provide for buyout of a partner's or shareholder's interest in case of his death.**
- ▶ **Protect against loss of revenue which would occur as a result of the death of a key sales or service executive/employee.**
- ▶ **Provide security to a lender (a bank e.g.) of the company in view of certain key executives**
- ▶ **Provide security to a investment banker in anticipation of a rollout of a new company or division**

### Settlement Event – Change in Circumstances

- ▶ **Company is sold prior to death of partner.**
- ▶ **Key Person has left the employment of the Company e.g. retired**
- ▶ **Unanticipated death of other (uninsured) partners or shareholders prior to the death of insured partner or executive.**
- ▶ **Company has filed for bankruptcy, or is otherwise in serious financial trouble.**
- ▶ **Company's debt structure has changed in some major way: has reduced or eliminated debt or a banking relationship, or changed debt structure in some way.**
- ▶ **Company's strategic plans have changed – is no longer anticipating a new business or public sale or other event that may have caused the need for the Key-Person insurance in the first instance.**

## Reasons to settle a policy – what to look for? (cont.)

### 1c. Charitable Situations

- Policy not needed and donation to charity contemplated
- Charity cannot afford premiums
- Option: donation coupled with a settlement
- Consider tax implications:
  - Donate policy – deduct CSV
  - vs.
  - Donate (more) cash – deduct the \$ amount
  - So, perhaps, settle first, then donate

## Reasons to settle a policy – what to look for? (cont.)

### 2. Replacement Situations

- Remember Conceptual Framework...I need it, and can afford it.
  - (Consider this instead of a 1035 exchange)
    - Case Study
  - \$5mm face UL policy
  - \$100,000 Annual Target Premium (TP)
  - Change of Circumstances?
    - Market improvements e.g. – this is an expensive policy compared to less expensive/enhanced products (guaranteed products).
  - New Policy
    - (Same) \$5mm face
    - \$120,000 TP
  - Settlement of existing policy
    - 12% of face, e.g. or \$600,000
    - Invest \$600,000 (aside from taxes) @ 4% = \$24,000
    - \$24,000 > \$20,000 +
    - \$600,000 increase in family wealth and security

## Reasons to settle a policy – what to look for? (cont.)

### 2. Replacement Situations

#### Case Study and “Arbitrage”

- **Definition:** purchase and sale of a commodity in 2 different markets at same time (for profit or improved financial situation)
- Purchase from Primary Market - \$120,000 TP
- Sell into Secondary Market - \$600,000
- Arbitrage exists to extent variance of medical opinion
  - Same medical records; carriers exam; buyers no-exam
- Economic forces drive arbitrage
  - Sales incentives to sell new policies
  - IMO/GA leverage over carriers to better ratings
  - Pressure on Buyers to utilize allocated funds

## Wrap-up and Conclusions

- Life settlement is an option that can be evaluated essentially with no risk or expense to client.
- Should be part of your arsenal of financial strategies in keeping with your fiduciary obligations.
- Is a detail-oriented transaction that must be done in coordination with experts who are in turn fiduciaries to you and your clients.

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