The Complete Life Settlements Handbook

How to Get the Most for Your Unwanted Life Insurance

Samuel Gerbyshak and James Van Depere
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Chapter 1

Summary

Life settlements are powerful tools for consumers to exchange unwanted or unneeded life insurance for cash. Unfortunately, most consumers know little or nothing about life settlements. The primary reason for this is that most of the people to whom consumers turn for financial advice—financial planners, attorneys, accountants, and insurance agents—are themselves uninformed or misinformed about life settlements. This book attempts to explain in plain English what life settlements are, when they are (or are not) useful, and how to get the best deal in the life settlements market. It is aimed primarily at consumers, but professionals who want to learn the basics of life settlements should also find it useful.

Basics

A life settlement is a transaction in which you sell a life policy that you own to a third-party investor. You receive a lump-sum cash payment from the purchaser for selling your policy. The purchaser becomes the new owner of the policy, and is responsible for future premium payments. When the person whose life is insured by the
policy (which may be someone other than you) passes away, the purchaser receives the policy’s benefit.

To understand why you might want to enter into a life settlement, you need to know a little about life insurance. Speaking very generally, life insurance consists of two types: term insurance and permanent insurance. Term policies provide coverage only for a certain period of time—for example, a 20-year term policy provides coverage for 20 years (provided that you pay the scheduled premiums). Permanent life policies provide insurance that does not normally expire. Whole life and universal life are common types of permanent insurance. Permanent life insurance also has a “cash value” that generally increases over time, while term life insurance has no cash value. If you decide to surrender (that is, cancel) your permanent life insurance policy, the insurance company will pay you the cash value of your policy.

Life insurance is an excellent financial tool, and there is no true substitute for it. However, as you age and your circumstances change, it is common to find that you no longer need—or want to pay for—the benefit offered by your policy. When this happens, most people simply surrender their policy and take any cash value that their policy may have accumulated. Relatively few people continue to pay their premiums until their deaths, even among people who have permanent life insurance. Milliman USA, a prominent actuarial firm, estimates that 88 percent of universal life policies never pay a death benefit, and more than 90 percent of all life insurance policies never pay a death benefit.
While surrendering a policy for its cash value is common and easy, savvy consumers know that a policy’s cash value (which may be reduced by surrender charges) does not usually represent its true economic value. This can put you in a terrible bind: Should you keep paying premiums—for years or even decades—on a policy that you don’t really want or need, so that your beneficiaries can receive its full value? Or should you stop paying premiums and just take the cash value, even if it is only a fraction of the policy’s true worth? With a term policy, the problem is even worse: You get nothing if you surrender it!

A life settlement can be an excellent solution to this dilemma. Instead of surrendering your policy to the insurance company, a life settlement lets you sell it to an investor. While your beneficiaries will not (with a few exceptions) receive any benefit after a life settlement, you will not have to pay further premiums and you will receive a larger cash payment than you would have from surrendering the policy. In essence, a life settlement lets you and an investor split the true economic value of your policy.

To recap, a life settlement is a transaction in which you sell your unwanted life insurance to an investor. You receive a cash payment for your policy, and the investor pays future premiums and receives the death benefit. The advantage of a life settlement is simple: You get more money by disposing of your policy through a life settlement than you would have by surrendering it to the insurance company.
Eligibility

Any policy owner who is legally competent can sell his or her policy. But not all policies are eligible for a life settlement. First, you must have purchased your policy at least two years ago to qualify. A policy that is less than two years old is contestable, meaning that the insurance company can dispute the validity of the policy under some circumstances. Because of this, investors won’t buy it.

Second, your policy must be of a type eligible for settlement. Fortunately, due to recent advances in the life settlements market, almost any type of policy may be eligible under some circumstances. Term life (if it is convertible into permanent life insurance), whole life, and universal life are all eligible for life settlements. Even group policies can be settled if your interest in the group policy is convertible into an individual policy. One exception is variable universal policies, which are difficult to settle because they are considered securities—fortunately, few people have these policies.

Third, you must have full legal control of your policy. If you have designated an irrevocable beneficiary, you will need the consent of the beneficiary to sell your policy. A more common problem is that your policy is actually legally owned by someone else. For example, the policy may be owned by a trust that is for your benefit, or by a business. In this case, you may need to secure the cooperation of a trustee or business partner in order to proceed.

Fourth, the person whose life is insured by the policy (who may not be you) must have a life expectancy of less than 20 years and
ideally a life expectancy of less than 12 years. Why is this important? The investors who buy your policy will not receive any return on their investment until the policy pays a death benefit. No investor wants to risk waiting and paying premiums for decades, so investors prefer to buy policies that insures the life of someone with a shorter life expectancy. As a practical matter, investors will not consider policies written on the life of someone who is under age 65 unless they have severe health problems, and are most interested in policies on the life of someone who is age 70 or older. The worse the health of this person is, the more interested investors will be. This means that smoking, high blood pressure, a family history of cancer, chronic conditions, and all the other factors that are undesirable for obtaining life insurance, are desirable for a life settlement.

Value

While most policies that meet the requirements we have just discussed are eligible for a life settlement, some policies are more valuable in the life settlement market than others. A number of factors determine what kind of offers you can get for a policy. Most obviously, the face value of the policy directly influences the size of offers—policies with bigger death benefits are worth more than policies with small death benefits. Policies with a face value of less than $250,000 are more difficult to sell, although policies as low as $50,000 can be sold.

The life expectancy of the person insured by the policy is another major factor. The longer the insured is expected to live, the
less a purchaser will offer for a policy. Outstanding loans previously taken from the policy also reduce the size of offers. Loans must be repaid, and generally purchasers will deduct any policy loans from their offers to account for the cost of repaying them. Premiums are also important to a policy’s value. Because the purchaser must pay the policy’s premiums until the insured dies, smaller premiums will lead to higher offers.

The above factors are the most important influences on your policy’s fair market value. Unfortunately, the money that an uninformed consumer receives from a life settlement may be far less than the policy’s fair market value. Life settlement prices are largely unregulated, meaning that offers for your policy will vary substantially from purchaser to purchaser. Unless you shop around for the best offer, you may not get a good deal. For the vast majority of consumers, the easiest and most effective way to solicit multiple offers is by retaining a good life settlement broker. A broker will contact many (sometimes dozens) of potential purchasers and negotiate the best possible price. Like real estate agents, brokers work on commission, so they have a strong incentive to get as much as possible for your policy. Brokers are paid by the purchaser of the policy, and do not get paid anything unless you actually decide to sell. We’ll discuss how to find a good broker later in this chapter, and at length in Chapter Eight.
Invariably, when we explain the numerous factors that determine the value of a policy, people still want to know what a typical life settlement yields. Good numbers are hard to come by, but here are the broadest figures available: According to the Life Insurance Settlement Association (an industry trade group), as of 2006 the average life settlement yielded 28 percent of the policy’s face value and about 400 percent of its cash value. In other words, a $1,000,000 policy that could be surrendered to the insurance company for $70,000 would probably be worth about $280,000 on the open market. Another survey conducted in 2008 by Life Policy Dynamics, a provider of portfolio management services, found that the average offer was 24.5 percent of the policy’s face value.

These are pretty exciting figures for most consumers, but remember: these are average figures based on past data. Unless you are one of those people who had 2.3 children, the odds that you will get offered exactly 28 or 24.5 percent of your policy’s face value or four times its cash value are pretty low. The life settlement market is young and still subject to rapid fluctuations. Most recently, the economic crisis of late 2008 and changes to standard mortality tables drove life settlement prices down substantially, even for excellent policies. This situation reinforces an uncomfortable truth about life settlements: The only way to truly establish the market value of your policy is by seeking offers through a competitive bidding process.

We do recommend, however, doing a little analysis before you dive into the life settlement process. At www.openlifesettlements.com, we maintain a free calculator that estimates the maximum value you could receive from a life settlement. If the value from this calculator is less than the minimum amount for which you would be willing to sell your life policy, you are unlikely to receive any satisfactory offers for a life settlement.
Reasons to Sell Your Policy… and Reasons Not to Sell Your Policy

Before we talk about how to sell your policy, let’s discuss whether a life settlement may be a good idea for you. Boiled down to the essentials, you should consider selling your policy only when it no longer meets your needs. Most people buy life insurance for income protection—they want to protect a loved one (or themselves) from financial need in the case of the insured’s death. The most common reasons for a life settlement are that the insured person has outlived the beneficiary, or the beneficiary has “outgrown” the need for insurance protection. For example, a husband may take out a policy on his own life and name his wife as the beneficiary. If his wife dies first, his life policy may be unneeded. Or a mother may take out a policy on the life of the father of her children, and name the children as the beneficiary. If the children achieve financial independence, the policy may become a burden instead of important protection. Another common reason for a life settlement is a change in estate planning. In general, a life settlement may be a good option in any case in which you would prefer to have cash now instead of a death benefit later.

The number one reason for not selling a policy through a life settlement is that the policy owner continues to need life insurance, but cannot obtain replacement insurance due to advanced age or poor health. There is no true substitute for life insurance. If you need insurance, either don’t sell your policy, or consider ways to sell only a portion of it. You should also consider the impact of a life settlement
on your taxes and estate planning. A life settlement is potentially a taxable event, and the proceeds of a life settlement may add to your estate. If you owe money to creditors, the proceeds of a life settlement can be seized by them. Also, a life settlement is income that may affect your eligibility for need-based government programs like Medicaid (but not Medicare). You should also consider alternatives to a life settlement, such as policy withdrawals, loans, accelerated death benefits, and arrangements with family. (Be careful of loans, however—as we’ll explain later, loans can rapidly consume your policy’s value and even leave you with a hefty tax bill.)

— IMPORTANT TIP ————

NEVER let a policy lapse or surrender one without considering a life settlement first. A life settlement will ALWAYS yield more cash than lapse or surrender. Why? Simply because no purchaser will offer you less money than the insurance company would give you—no one would ever accept the offer!
The Process

If you decide that a life settlement might make sense for you, the next step is to retain a trustworthy life settlement broker. A life settlement broker is a professional (usually working for a life settlement brokerage firm) who matches people who want to sell their life insurance policies with investors who want to buy such policies. Using a broker does not require any upfront fee or commitment because brokers are paid a commission by the purchaser if you sell your policy. Very importantly, however, a life settlement broker works exclusively for the seller, not the buyer. Just as you would want your own agent in a real estate transaction, you will want your own representation in a life settlement.

Fortunately, you can select an excellent broker who works with a superior brokerage firm by looking for a few objective qualities. All excellent brokers are independent, and work with as many reputable purchasers as possible. Excellent brokers are also transparent. They avoid conflicts of interest, and will provide you all the information you need to verify the quality of their performance. Superior brokers work for brokerage firms that concentrate exclusively on life settlements. This gives them the ability to access resources and purchasers that simply aren’t available to casual brokers. Superior brokers will also assign you a personal case manager at their brokerage firm to provide a single point of contact regarding your life settlement. We will discuss all these qualities in detail in Chapter Eight.
Once you find your brokerage firm and broker, they will guide you through the process of seeking offers for your policy. The details of this process are complex, but almost all of the work will be done by them. Your chief concern should be monitoring your broker and his or her brokerage firm to ensure that they are performing professionally.

Assuming that you have already discussed the basics of your policy with your broker, the first step will typically be to complete the broker’s application forms. These forms do not commit you to selling your policy; rather, they provide the broker with the information and legal authorization that he or she needs to seek offers for your policy. The application will require you to fill in basic information about yourself, the insured (if you are not the insured), and often the policy’s beneficiaries. You should also be prepared to provide basic information about your policy, such as the insurance company’s name and your policy number—hit the filing cabinet before you start! An application will include questions about divorces, bankruptcies, and past attempts to sell the policy. Answer these questions completely and truthfully—failing to disclose such information could delay closing or even lead to an offer being revoked. You will also be required to list some medical information about the insured. This may include a medical questionnaire, and will always include the name and contact information of the insured’s physicians (including specialists).
Although a broker’s application does not commit you to selling your policy, it has important legal consequences that you should carefully consider before you sign. First, it authorizes a broker to share the information you give him or her with others for the purpose of seeking offers for your policy. Second, it authorizes the broker to contact your insurance company to get your policy information. Third, an application often includes legal representations that you must make. These representations typically include affirming that you are the legal owner of the policy, and that you are not entering a life settlement for an unlawful purpose. Finally, a broker’s application includes a “HIPAA release” that gives the broker permission to request the insured’s medical records and to share these records with potential purchasers.

That last point is usually the most sensitive part of the application process for most people. As you may know, the federal law known as HIPAA protects the privacy of medical records. Because the life expectancy of the insured is vital to establishing a policy’s value, purchasers will want to review the insured’s medical records to determine his or her life expectancy for most life settlements. (Some small policies may not require the release of medical records, although you may be requested to sign a HIPAA release anyway.) Thus, the person whose life is insured by the policy must agree to waive his HIPAA privacy rights for the purpose of seeking offers. A broker’s application cannot be completed without the consent and signature of the insured to release his or her medical records.
Although some people are uncomfortable with the thought of others reviewing their medical records, most people find the actual process, which is conducted by professional underwriters, to be unobtrusive.

Once a broker has a completed application in hand, and has gathered policy details and any needed medical records, he or she will package the information and request offers from entities known as life settlement providers. Providers are the legal purchasers of life policies, but they generally serve as gateways and administrators for other investors (such as pension funds and university endowments) who will ultimately own the policies. A good broker will usually arrange for several rounds of competitive bidding to obtain the highest possible offer. Throughout the process, he or she should keep you informed about the bids received. For each bid, a transparent and trustworthy broker will disclose the offer to you and the commission the broker would receive.

If you decide to accept an offer, the life settlement provider will prepare a closing package. The closing package will contain multiple legal documents that make up the contract between you and the provider, and must be carefully reviewed with the help of your broker, and, if desired, your lawyer. The signed contract will be sent to a third-party escrow agent. After the provider places your money into escrow, the escrow agent will instruct the insurance company to transfer the policy to the provider. The closing process usually takes several weeks to complete (or even longer, if a term policy is
being converted as part of the sale, or an insurer is uncooperative), but once the provider receives title to your policy, the escrow agent should release your money within 72 hours.

If you change your mind about selling your policy, you can rescind (that is, cancel) the transaction for a short period after closing. Most states require life settlement contracts to contain a right of rescission that is good for between 10 and 15 days after you receive your money. Make sure that you understand your rescission rights before you sign a life settlement contract. Some rescission rights may require you to pay administrative expenses in addition to returning the money.

After you receive your life settlement, you can use the money as you please. However, you should be certain to talk to your accountant or a tax professional as soon as possible. A life settlement is often a taxable transaction, so you will need to plan to pay any federal, state, and local income taxes that are due. You will not be required to pay any future premiums on your former policy, nor will your beneficiaries receive any benefit when the insured dies. From time to time, the new policy owner may contact the insured (or another designated person, such as a doctor or relative) to verify that he or she is still alive. The details of these inquiries, including limits on the frequency of contact, will be specified in the life settlement contract. Typically, inquiries are discretely made by professional tracking services no more than a couple of times per year.
How to Use the Rest of This Book

We hope this summary has given you a good basic understanding of life settlements. The remainder of this book contains detailed information about the topics discussed in the summary. If you would like to quickly evaluate your own situation, we suggest you start by reading Chapters Four and Five. These chapters will help you decide if a life settlement makes sense for you. If it does, fill out the eligibility worksheet in Chapter Six to estimate if you are eligible for a life settlement and then contact a life settlement broker for assistance. Tips on how to select a good broker are located in Chapter Eight.

We also recommend visiting the Web site for this book at www.lifesettlementshandbook.com for updated information and additional content.
The History and Concept of Viatical and Life Settlements

A Life Insurance Primer

The concept of life insurance, which dates back at least as far as Roman times, is familiar to virtually every American: In return for regular payments, a company will pay money to one or more persons upon the death of the insured person.

Life insurance is so pervasive in America that you are probably familiar with much of the terminology and jargon of the insurance industry. The person whose life is being insured is called the insured, and the person who will receive a benefit when the insured dies—the person who is covered by the policy—is called the beneficiary. Premiums are the regular payments made to the insurer, which is often referred to as the “insurance company” or “carrier” because it is always a legal entity rather than a human being. A policy usually has a face value, which is the amount of money that will be paid if the insured dies.
Although you may not have thought about it specifically, you probably also know that the owner of a policy does not need to be the person whose life is being insured. Frequently, for example, a husband or wife owns a policy that insures the life of his or her spouse. It is also common sense that policies will not be ready to pay a benefit—will not be *in effect*—if the policy has expired by its terms, or if it has lapsed because premiums have not been paid.

You may be less familiar with the different kinds of life insurance, which come in any number of variations. Broadly speaking, however, we can divide life insurance into two types: *term* and *permanent*. Term policies are those that provide coverage only for a certain period of time. For example, if you buy life insurance with a ten-year term, the policy will expire (or the premiums will increase) after ten years. Although term insurance comes in many varieties, it is generally easy to understand how it works.

Permanent insurance can be more complex. Permanent insurance does not expire, and, generally speaking, as long as premiums are paid, a permanent insurance policy will remain in force until it pays a benefit at the insured’s death. Most permanent policies are cash value policies. These policies can be *surrendered* in exchange for a cash value that they accumulate over time. Two major types of cash value policies are *whole-life insurance* and *universal life insurance*.

Whole-life insurance generally requires you to pay premiums over the entire life of the policy, but these premiums are usually
level. Whole-life thus allows you to avoid the problem of having to pay higher premiums as you age. Whole-life insurance builds cash value at a rate specified by the policy. Some policies provide for guaranteed interest on accumulated cash value, others allow you to receive a share of the insurer’s profits, and still others—called variable life policies—allow you to direct the investment of the policy’s cash value yourself.

Universal life insurance is a flexible type of insurance that allows you to change the amount of coverage and your premium payments as your circumstances and preferences change.

Universal life is best understood as insurance funded by a cash account. The cost of insurance is not fixed as it is in whole life insurance. Rather, the actual cost of insurance is taken from the cash account. The cash account, in turn, is funded by your premium payments. Ideally, the cash account will build up value over time because your premium payments and the investment returns of the cash account exceed the insurance costs. The eventual goal is usually for the cash account to completely pay for the cost of insurance even if you no longer make premium payments. As with whole-life insurance, a universal life policy credits the cash account with interest or dividends based on terms set by the policy. The cash account will often pay a certain guaranteed minimum interest rate. Additional credits may be based on the performance of the insurer, based on investments selected by you, or determined by other criteria. While universal life insurance is very flexible, a common problem with universal life policies is that if the cash account runs low on money
due to poor investment performance, you may find yourself making unexpectedly large premium payments to maintain coverage—or, in some cases, having no coverage at all!

Because both whole and universal life policies are cash value policies, you can always surrender a policy in exchange for its cash value. (In some cases, surrender charges or other fees may be deducted from the cash value.) Most people hope that their whole or universal policies will eventually accumulate a large cash value. They then plan to borrow from or against that cash value, or even withdraw it (if permitted by the policy), so that they can use the cash value that their policy has built up. Whole or universal life insurance can be used in this way as a savings vehicle, rather than just a means of providing insurance protection.

A life insurance policy is often one of an American family’s biggest assets. Insurance companies encourage policy owners to store wealth in permanent insurance policies by promoting their use as an investment and savings vehicle. Despite the heavy promotion of life insurance as a general-purpose investment, life insurance has major drawbacks when viewed purely as an investment and savings vehicle.

First, no life insurance product puts all of its value into producing investment returns. All life insurance products retain an insurance component. No matter how it is designed, life insurance is ultimately about providing money to a beneficiary at the death of an insured. If the death of someone in your family would leave you or
another family member in need of money, there is no substitute for the protection offered by life insurance. Conversely, a change in your circumstances can make the protection of life insurance unwanted or unneeded. Investing your money in a product that is primarily designed to deliver life insurance protection that you no longer need is a waste of your assets.

Second, in exchange for the guaranteed benefits and returns of a life insurance policy, an insured must accept some limitations. It can be hard to extract cash from a life insurance policy. In addition, although some policies are designed to have premiums that decline over time, the owner of the policy is responsible for paying any premiums due. If you cannot afford to pay your premiums, the value of your life policy may completely vanish. Furthermore, while some universal life policies offer a wide variety of investment choices, most policies provide little or no flexibility to invest as you wish.

While both of the disadvantages discussed above can be serious drawbacks for the owner of a life insurance policy, it was the relative inflexibility of life insurance that led to the creation of the life settlements market. The section below discusses the early origins of this market.
Viatical Settlements and the AIDS Crisis

During the late 1980s and early 1990s, the AIDS crisis drastically shortened the life expectancy of thousands of people, many of whom were relatively young. AIDS victims often had a tremendous need for immediate cash. The average cost to treat an AIDS patient from the onset of the disease until death was estimated at $69,000 in the early 1990s—a lot of money given that a victim was lucky to live two years after the diagnosis. Further adding to the problem, some insurance plans were slow to add coverage for anti-AIDS drugs, meaning that AIDS victims needed cash in hand to get what little effective treatment was available. Life insurance was often one of the few assets a young AIDS victim possessed, yet most policies could not adequately meet an immediate need for cash. Even those who did have liquid assets were burdened with life policies that often had been purchased as a retirement savings vehicle, and were now no longer needed. Unsurprisingly, a very large number of AIDS sufferers wished that they could get cash immediately rather than a payment after they died.

AIDS victims initially found it hard to get a fair cash value for their life insurance policies. Because they were highly likely to die within a few years, the life insurance policy of an early AIDS sufferer was worth a lot of money in economic terms. But because victims were usually young, the policies of many victims had built up little cash surrender value. AIDS sufferers thus faced a Catch-22 situation: If they held onto their life insurance policies, they were virtually certain to receive a large benefit within a few years—but
only after they were dead and unable to use the money. (Moreover, in the meantime they would have to keep making premium payments.) Alternatively, they could surrender their policy to the insurance company and receive immediate cash—but the payment would be only a small fraction of the policy’s actual value.

Beginning in 1989, AIDS victims began entering transactions called *viatical settlements*. In a viatical settlement, an investor buys an existing insurance policy that covers the life of someone who is terminally ill. The person selling the policy, who is called the *viator*, receives an immediate cash payment that is substantially more than the cash surrender value of the policy. (Both terms are derived from the Latin ecclesiastical term *viaticum*, which literally means provisions for a long trip.) The investor, who is termed a *viatical settlement provider*, becomes the new owner of the policy. The viatical settlement provider pays the premiums on the policy and receives the benefit when the viator dies.¹

Viatical settlements usually were win-win deals for both viators and investors. Viators got more cash from a viatical settlement

¹ Although the idea of a viatical settlement seemed tremendously novel in the early 1990s, the legal foundation for viatical settlements dates back to the 1911 Supreme Court decision in *Grigsby v. Russell*. In that case, a patient sold his life policy to a doctor for $100 to pay for an operation. The doctor had difficulty collecting the benefit of the policy when his client passed away, and appealed all the way to the Supreme Court. There the great Justice Oliver Wendell Holmes upheld the doctor’s right to collect the benefit. Justice Holmes reasoned that a life insurance policy was personal property and therefore assignable (transferable). This basic legal principle remains the law a century later.
than they would have from surrendering their policy. Investors got a chance at an investment return that was typically far greater than a conventional investment.

Despite generally favorable results and rapid growth, viatical settlements eventually developed an unsavory reputation. A few viators were defrauded by dishonest viatical settlement providers that promised large payments but did not deliver in a timely fashion. Some viators (or their former beneficiaries) also regretted accepting low offers for their policies. More commonly, individual investors fell victim to unscrupulous viatical settlement providers who promised large investment returns. Many small investors did not understand the risk inherent in any investment in a viatical settlement. When, for example, new AIDS drugs were invented, viatical settlement investments that had seemed like a sure thing became money-losing deals for investors. Some investors were swindled by fraudulent viators who lied about having AIDS so that they could receive a huge return on a recently issued life insurance policy. Insurance companies also fell victim to fraud, when people who knew they had AIDS lied on life insurance applications and exposed the life insurance company to huge risk. Finally, there is just something a little ghoulish about profiting from someone’s imminent death. Even though anecdotal evidence suggests that viators are usually satisfied with their viatical settlements, many people believe that viatical settlement providers take advantage of vulnerable people in stressful situations. All the above factors led to increased pressure to regulate viatical settlements.
Reactions: Accelerated Death Benefits, Increased Regulation

Insurance companies did not remain passive as viatical settlements grew in popularity. Insurers reacted by offering *accelerated death benefits* (sometimes called “living benefits”) in some policies to allow the terminally or catastrophically ill easier access to cash. These benefits, which are increasingly common in newer policies, allow the beneficiary to receive some or all of the policy’s death benefit when a specified triggering event happens to the insured. The covered events vary from policy to policy, but usually include terminal illness (e.g., a life expectancy of less than 12 months), catastrophic illness requiring extraordinary treatment, and sometimes long-term care. Accelerated death benefits may result in higher premium charges or interest charges on the accelerated benefit, but, when available, they are often an effective alternative to viatical settlements.

The rise of viatical settlements also did not escape the notice of the government. At the federal level, favorable laws and legal decisions contributed to growth in viatical settlements. In 1996, Congress passed the Health Insurance Portability and Accountability Act (HIPAA). HIPAA equalized the tax treatment of life insurance benefit payments and viatical settlements. After the passage of HIPAA, payments from viatical settlements were excluded from personal income tax just as with the payment of a life insurance benefit. Also in 1996, the federal Securities Exchange Commission (SEC) attempted
to regulate the sale of viatical investments as securities (i.e., as an investment like a stock or bond), but an appellate court ruling held that the SEC did not have authority over viatical settlement investments.

The failure of the SEC to regulate viatical settlements contributed to more aggressive regulation of viatical settlements at the state level. Regulators increasingly demanded that viatical settlement providers comply with state securities laws—and successfully enforced these demands in court. Legislatures passed laws giving state insurance commissioners the power to regulate viatical settlement providers, contracts, and advertisements. Many of these laws are based on model acts drafted by the highly influential National Association of Insurance Commissioners (NAIC). As a result, viatical settlements are now regulated in most states.

The Creation of Life Settlements

By the mid-1990s, viatical settlements were commonplace. As AIDS treatments improved, viatical settlement providers expanded the market to include other terminally ill people, such as cancer victims. Inevitably, providers began offering to buy the policies of people who were not terminally ill. These transactions became known as “life settlements” or—because they are almost always aimed at senior citizens—“senior settlements.”

A life settlement is identical to a viatical settlement, except that the insured is not terminally ill. This difference is important legally
because it leads to different tax treatment (and sometimes regulation) of the transaction. More importantly, deciding whether a life settlement is a good deal is harder for both the policy owner and the settlement provider. The policy owner must decide whether it would be better to have cash now or a death benefit later under circumstances in which there may not be an obvious right answer. The settlement provider must carefully decide how long the insured is likely to live before making an offer. A mistake may leave the provider responsible for years of costly life insurance premiums in return for a distant payout.

The Expansion of Life Settlements

The market for life settlements is inherently larger than that for viatical settlements for the simple reason that there are far more senior citizens than there are younger people with terminal illnesses. The viatical settlements market peaked around 1998, when policies with a total face value of about $1 billion were viaticated. By 2002, however, the life settlements market was roughly double that size.

As life settlements grew in popularity, they became subject to government scrutiny and state regulation just as viatical settlements had before. The NAIC created a model act in 2000 to regulate life settlements that was adopted over the next few years in various forms by a number of states. Another group, the National Conference of Insurance Legislators (NCOIL), also drafted model legislation that was adopted in several states. Although a number of states that regulate viatical settlements still do not regulate life settlements, the clear
trend has been to subject life settlements to the same regulations that apply to viatical settlements.

Despite increased regulation, the life settlements market has continued to expand, growing from $3.3 billion in 2004 to $6.1 billion in 2006 to an incredible $15 billion in 2007. Life settlements slowed in 2008 due to recession and mortality table adjustments by major underwriters. But given that senior citizens are estimated to hold more than $500 billion in life insurance, further growth of the life settlements market remains likely.

The Future: A Robust Secondary Market?

The future of the viatical and life settlements market will be determined by the clash of several competing interests. Consumers are increasingly interested in flexibility in their financial products. Life insurance is no exception. As the baby boomers enter retirement, the hundreds of billions of dollars of life insurance policies they hold will continue to expand an already massive potential market for viatical and life settlements.

A number of economists believe that continued growth in viatical and life settlements will be a boon to consumers. These economists explain that viatical and life settlement providers create a secondary market for life insurance. A secondary market exists when the purchaser of a financial product can sell his or her rights in it to a third party. Economists point out that secondary markets exist for many other consumer financial products, including mortgages and stocks.
For example, a bank will frequently resell a consumer’s mortgage to a third party. This allows the bank to reduce its risk, and, in theory, offer lower prices to consumers. Similarly, a consumer can easily turn a publicly traded stock into cash by selling it to someone else. The stock market would not be very popular if investors could only sell their stocks back to the corporation!

Large, institutional investors such as pension funds also generally support the growth of viatical and life settlements. These investors believe that such settlements offer both an attractive return and the potential to diversify their portfolios (that is, the potential to lower the risk of large losses). By 2007, institutional investor interest was sufficiently commonplace to support the creation of a trade group called the Institutional Life Markets Association, which is led by a number of prominent investment bankers.

Insurance companies take a mixed view toward the expansion of the viatical and life settlement markets. Some insurers have publicly expressed support for viatical settlements, but most take a much dimmer view of life settlements. A number of insurers discourage or even ban their life insurance agents from discussing or transacting life settlements with clients.

Some of the opposition of insurance companies to life settlements undoubtedly stems from self-interest. Insurers usually would be better off if the policies purchased by life settlement providers were surrendered or allowed to lapse. Insurers fear that the growth of life settlements will reduce the lapse rate of their policies, and
thus undermine the assumptions of their premium pricing models. Beyond the fear of a gradual erosion in lapse rates, insurers are deeply concerned that the emergence of a large secondary market in life insurance could cause Congress to view life insurance primarily as an investment. Insurers believe that this could lead to the loss of life insurance’s special tax exemption. Currently, a death benefit paid by life insurance is not taxable. If these payments were taxed as investments, life insurance would be a much less attractive product, and many of the most profitable life insurance policies would no longer be viable.

The attitude of state regulators towards viatical and life settlements varies widely from state to state. Some regulators view viatical and life settlements as a threat to carefully developed insurance systems. Others think that viatical and life settlements are largely beneficial to consumers, and require only light regulation. The NAIC has clearly favored increased regulation, but has not pushed for the elimination of viatical or life settlements. Regulators are, however, intensely concerned about a practice called Stranger-Originated Life Insurance (STOLI).

In a STOLI transaction, a “stranger” convinces a person (usually a senior citizen) to buy an insurance policy for the express purpose of selling it to someone else. Initially, STOLI was pushed by promoters who earned commissions on the sale of insurance policies and then a further commission if a life settlement occurred. Because few investors will consider buying policies that have not passed out of the two-year incontestability period, consumers needed to pay pre-
miums for at least two years before attempting a sale. Frequently, no purchaser materialized, leaving the consumer out two years worth of premiums. More recently, STOLI promoters have offered consumers “free” life insurance financed by loans. Often these loans are “non-recourse,” meaning that the lender cannot take anything other than the life policy if the borrower fails to repay the loan. These STOLI schemes can seem appealing even to financially savvy consumers, but they carry hidden tax and legal risks. STOLI financed with non-recourse loans creates the risk of owing taxes on forgiven loans or “free” insurance. STOLI schemes may also require the policy owner to misrepresent the purpose of obtaining the insurance or the insured to misrepresent his or her health. Both types of misrepresentation can constitute fraud when made on an insurance application. Fraud can trigger unexpected liabilities to the lender, who is often indemnified against losses caused by the consumer’s fraud, and even an outside chance of criminal prosecution. Regulators, insurers, and all major life settlement providers are opposed to STOLI transactions. Regrettably, some insurers and regulators also view the problem of STOLI as a convenient excuse to check the growth of the legitimate life settlement industry.

In the future, life settlements will likely be more widely and heavily regulated. But, given the compelling advantages to consumers of a secondary market for life insurance, it is likely that life settlements are here to stay. Whether this market becomes robust and efficient will largely depend on whether relatively uniform laws and regulations are adopted by the states, or whether the regulation
of life settlements becomes a patchwork quilt of conflicting state requirements.

In the opinion of the authors, uniform rules will allow the development of an efficient market that will benefit both consumers and investors. An inefficient market, on the other hand, will not destroy the life settlement industry—the need for a life insurance secondary market is simply too real. But an inefficient market will lead to waste that will profit a few at the expense of many.
Chapter 3

Policies Eligible for a Life Settlement

Not every policy is eligible for a life settlement. Whether a policy is eligible depends on two main factors: the life expectancy of the insured, and the characteristics of the policy. Let’s examine life expectancy first.

Life Expectancy: Lower Is Better

It goes almost without saying that the cost of life insurance depends heavily on life expectancy. If an insurance company expects an insured to live a long time, the insurance company will charge lower premiums because they don’t expect to have to pay a benefit soon. On the other hand, if the insurance company thinks an insured is a greater risk because he or she may not live very long, the insurance company will charge higher premiums. Thus, the longer your life expectancy, the better off you are in the life insurance market.

The life settlement market works in exactly the opposite way: The lower the insured’s life expectancy, the more your life insurance policy is worth. Buying the policy of an insured who is older,
or who faces health challenges, is to the advantage of life settlement providers for two reasons. First, the shorter the insured’s life expectancy, the sooner the provider is likely to receive the policy’s benefit. Second, the shorter the life expectancy, the less time the provider must pay premiums on the policy. Because a shorter life expectancy means less risk, life settlement providers will offer more for the policy of an insured who is older and less healthy.

Most life settlement providers look for candidates with life expectancies between 2 and 12 years. (People with life expectancies of less than two years are candidates for viatical settlements, which, as we mentioned in the last chapter, are similar to life settlements but designed for the terminally ill.) Some life settlement providers will buy the policies of those with life expectancies up to 15 years. People with life expectancies longer than 15 years are rarely good candidates for a life settlement—few investors are willing to pay substantial sums for a policy that may not yield a benefit for many years.²

Because a shorter life expectancy increases the value of offers, life expectancy factors that would work against you in the insurance market are actually advantages if you are contemplating a life settlement. Below are some of the specific factors that life settlement providers evaluate when determining an insured’s life expectancy.

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² Some policies insure the lives of a couple, and pay a benefit only after both insureds die. For these policies, a joint life expectancy must be determined. A joint life expectancy is usually a bit longer than the life expectancy of the person who is expected to live longer.
**Age**

Age is often the most important factor in a person’s life expectancy. Life settlement providers view the policies of older insureds as much lower risk. When asked to describe the ideal life settlement candidate, most life settlement providers will specify an age of 75 or even 80. A life settlement is rarely an option if the insured is under 65, unless he or she suffers from serious health problems. Insureds who fall between 65 and 75 may be eligible for a life settlement, but usually will obtain much better offers if they have a documented health problem or condition. Because of advances in modern medicine, life settlement providers simply cannot assume that an insured who is 70 will not live to be 85 or 90—and neither should you!

**Gender**

The average man has a life expectancy several years less than the average woman. Generally, men are eligible for a life settlement at younger ages than women are. (As a rough guide, expect a man to be treated about the same as a woman who is three to five years older.) This does not necessarily mean, however, that men will receive a better deal from a life settlement. As you will see later on, many factors determine the amount paid for a policy.

**Health**

Health is obviously a major factor in life expectancy. Every health factor that could conceivably affect the insured’s life expectancy is important. This includes basic information such as weight, blood pressure, and diseases and sicknesses of all types. However, some very serious conditions are afforded less weight than one might ex-
pect. Heart bypasses, past cancer, and HIV infection, for example, often cause a surprisingly modest decrease in life expectancy. On the other hand, factors that might seem harder to evaluate—such as exercise, social activity, chronic conditions (like diabetes and high blood pressure), and even family history—can substantially impact life expectancy.

**Life Expectancy Estimates**

Now you know what factors go into a life expectancy calculations, but how are these calculations actually made?

Most commonly, life expectancy calculations are produced through a medical underwriting process that involves a review of medical records from all of the insured’s medical treatment providers. Although some life settlement providers underwrite in-house, most life settlement providers rely on one or more of the half-dozen national life settlement underwriting services to compute a person’s life expectancy. These underwriters will generally want to see the insured’s complete medical records for at least the last five years.

Once they have the insured’s medical records, the underwriters will review these records for any factors that might decrease or increase life expectancy. They will then add and subtract these factors from mortality curves based on people with similar characteristics. The final life expectancy is usually expressed in months. This figure, along with a summary of the factors considered by the underwriter, is placed on a life expectancy certificate that is mailed or e-mailed to the provider or broker.
Will I have to undergo a medical exam?

It is rare for a life settlement provider or broker to ask an insured to undergo a medical exam. If the insured hasn’t had a physical in the last two years, or has recently developed a health condition, he or she might be asked to get a medical exam. Remember that fully revealing the insured’s medical problems is to your advantage, so if you are considering a life settlement on a policy that insures your life, you may want to prepare by having your regular physician perform a complete examination, including providing you a prognosis on any serious health conditions. A little extra effort in documenting any medical problems may help you get a better life settlement offer. More importantly, getting a better understanding of your health will help you decide whether a life settlement makes sense in the first place.

Because life settlement providers pay less for the policies of insureds with greater life expectancies, you might expect that underwriters would tend to overestimate life expectancies in order to gain favor with their clients. In fact, until recently the opposite was true: Underwriters tended to underestimate the life expectancy of insureds. Many people in the life settlement industry believe this occurred because of competitive pressures from life settlement providers and brokers. Providers are usually working on behalf of outside investment funds, and their pay is based more on volume than long-term investment results. Brokers get paid only when a transaction closes.
Both thus had incentives to patronize underwriters who wrote shorter life expectancies. In late 2008, this regrettable situation changed when one provider, 21st Services, increased its mortality tables by up to 25 percent. Other underwriters followed suit, resulting in longer life expectancies and smaller settlements.

Despite all the fluctuations in results, the major players in the life settlement underwriting business remain the same. The three most important are AVS, 21st Services, and Fasano. If a case requires full underwriting, it is rare (and questionable) for a broker not to order life expectancy reports from at least two of these top three services.

Gathering medical records and ordering life expectancy reports is expensive. For small policies with a face value of $500,000 or less, full medical underwriting often does not make economic sense. Some life settlements providers will consider buying such small face value policies without full medical underwriting. These providers rely on standard mortality tables, or life expectancy estimates generated by a computer review of basic health information. To generate this kind of life expectancy estimate, the insured will have to complete a paper or computer medical questionnaire, or undergo a short phone interview regarding his or her health. (If you are curious, you can order an online computer review of your own life expectancy for about $60 from 21st Services, a leading life expectancy provider.)
Impact of Sex, Age, and Health on Life Settlement Eligibility

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<thead>
<tr>
<th>Age</th>
<th>Male</th>
<th>Female</th>
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<tr>
<td>66-70</td>
<td>Must have serious health problems</td>
<td>Highly unlikely to be eligible</td>
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<tr>
<td>71-75</td>
<td>Eligible with some health problems or conditions</td>
<td>Must have serious health problems</td>
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<tr>
<td>76-80</td>
<td>Likely eligible; great candidate if some health problems</td>
<td>Eligible with some health problems or conditions</td>
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<tr>
<td>81-85</td>
<td>Great candidate</td>
<td>Likely eligible; great candidate if some health problems</td>
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<tr>
<td>86+</td>
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Characteristics of the Policy

Determining whether the insured’s life expectancy is within the qualifying range is only half of the equation, however. You must also determine whether your policy has the characteristics needed to make it a good candidate for settlement.

There are many factors which make a policy suitable (or unsuitable) for settlement, but let’s start with the absolute minimum requirements. To be eligible for life settlement, a policy must be:
A policy must meet the above three requirements to be eligible for a life settlement. Below we will explain each requirement in detail.

**Transferable**

A policy is transferable if you have ownership of the policy and the ability to transfer that ownership to someone else. It may seem fairly obvious to you that you can’t sell what you don’t own, but before you skip ahead, think about your life insurance policy for a moment. Do you know for certain who owns it? It is very common, for example, for one spouse to own a policy on the life of another. Even if you have been paying the premiums on a policy for many years, you may not be its legal owner. The owner of the policy is the only person with the authority to transfer it. If you are not the owner of the policy, you must involve the owner in the life settlement decision process—only they can ultimately decide whether to settle the policy.

Life insurance is also often placed in a trust. Even if you created the trust, or are its only beneficiary, the trustee is the legal owner of the policy. In these cases, the trustee must settle the policy, and whether you will receive any of the proceeds will be determined by the terms of the trust.
You may also benefit from a policy that you think of as your own that is actually owned by a business. A common scenario is for a business to take out a life insurance policy on a key executive. Key man insurance is owned by the business, and can only be sold by the business. It also is common for a person to have life insurance through a group contract. Many employers, for example, offer life insurance coverage to employees. Although you may have *rights* under a group policy, you do not *own* the policy and thus cannot sell it. Fortunately, coverage under most group policies can be converted into an individual policy that you do own. You should contact the administrator of your policy or the insurance company for more information about conversion.

If you do have ownership of a policy, you can almost always transfer ownership of that policy to another person. In rare cases, however, the terms of a policy or state law may prohibit transfer. It is questionable whether insurance contract provisions that purport to restrict your ability to transfer ownership are enforceable, but such provisions may make a settlement more difficult. No state has a law that broadly prevents the transfer of life insurance policies. A few states, however, place restrictions on sales that are part of life settlements for as long as five years after the purchase of the policy. These restrictions are primarily designed to combat STOLI. Even these states, however, have exceptions if changed circumstances lead to the sale of the policy.
**Incontestable**

A policy is incontestable if the insurance company cannot legally dispute the policy’s validity. All states require life insurance policies to contain a clause that makes the policy incontestable after two years. In other words, two years after you are issued a policy, it cannot be revoked even if it was improperly issued or applied for.³

Life settlement providers do not want to buy a lawsuit. There is enough uncertainty involved in purchasing life insurance policies without adding legal uncertainty to the list of concerns. Most life settlement providers simply will not buy a policy unless it is incontestable. Before you seriously consider selling any life insurance policy, make sure that it was issued at least two years ago and is incontestable.

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³ In some states, outright fraud on the application—not just a mistake, but an intent to mislead—may lead to the cancellation of the policy even after the incontestability period. Also, it may be possible for the insurer to cancel a policy if there was a lack of “insurable interest” at the policy’s inception. Insurable interest means that the policy owner had an interest—either through love and affection, or through financial or business ties—in the life of the insured. Note that the insurable interest requirement only applies at the time a policy is created. A lack of insurable interest by a subsequent purchaser of the policy does not affect a policy’s validity, except perhaps if there was a scheme prior to the inception of the policy to circumvent the insurable interest requirement. Insurable interest should never be a problem in a life settlement except if the policy is part of a STOLI scheme.
In Effect for the Rest of Your Life

A life settlement provider can’t make a profit if your policy expires before it pays a benefit. Indeed, the lapse of a policy is a disaster for a life settlement provider, because the provider will have paid a cash settlement and premiums without receiving anything in return. Consequently, life settlement providers will not buy a policy unless it is certain (or very close to certain) that the policy can remain in force throughout any length of time that you are likely to live.

This requirement isn’t a problem for whole life or universal life. Whole life insurance cannot lapse so long as the premiums are paid, no matter how long you live. (It is, however, not always a good candidate for a life settlement because older whole life policies tend to have high cash values that may exceed what a life settlement would produce.) Although an underperforming universal life insurance policy can lapse even if the target premiums are paid, a universal policy can always be kept in force if the rate of premium payments is increased. Moreover, many more recent universal policies have no-lapse guarantee riders that prevent lapse so long as minimum premium payments are made.

While it is very commonly settled, term life insurance is the type of insurance most likely to pose a problem. Typically, a term policy must be converted into a whole or universal policy to be eligible for settlement. Most term policies have such a conversion right, but it is usually available for a limited time. If you are thinking of selling a term policy, start by checking your policy to see if it is still convert-
ible. If it is not, you probably are not eligible for a life settlement. A few providers, however, will consider even non-convertible term policies if they are guaranteed to be renewable to at least age 90.

**Beyond the Basics: What Affects Value?**

Now that we have covered the requirements your policy must meet to be eligible for a life settlement, let’s look at the factors that make a policy more or less valuable. Most of these factors have dollar signs associated with them—face value, premiums, loans, insurer strength rating, and other factors have a major impact of settlement eligibility and the value of offers.

**High Face Value**

Any life settlement transaction involves significant overhead costs. Because life settlement providers want a sizeable reward in return for this cost, they prefer to deal in policies with large face values. In the past, few life settlement providers would consider policies that paid a benefit of less than $250,000. Recently, major life settlement providers have started to accept policies with face values as low as $100,000, or, in some special cases, even $50,000. Some of these providers offer a streamlined underwriting process for small policies that allows them to make offers faster and with less information.

According to a survey conducted by Life Policy Dynamics, in 2008 the median face value of a settled policy was $1,000,000. This figure has remained remarkably steady over time, and appears to be
the “sweet spot” for a life settlement. Investors appear to demand higher internal rates of return for investments in smaller policies, and many providers will not consider small policies. That is bad enough, but these policies are also more difficult to sell because life settlement brokers are less willing to invest resources in them. As we mentioned earlier in this chapter, most life settlement providers require full medical underwriting. If a broker is selling the policy, that broker is responsible for gathering medical records and ordering life expectancy reports for the providers. Paying for these items would make most small cases unprofitable for brokers. Consequently, brokers will submit most small policies only to life settlement providers that do not require full underwriting. The resulting reduction in competition makes it more difficult to obtain attractive offers for small policies. Nonetheless, about one-eighth to one-sixth of all policies sold are $500,000 or less.

Although larger is generally better, extremely large policies pose challenges of their own. Although policies of $5 million to $10 million are commonly sold, policies larger than this have a more limited market. This is because major life settlement investors prefer to hold portfolios with many policies to reduce risk. Holding a very large policy in an investment portfolio means that a single unexpected event—such as that policy’s insured living much longer than expected, or an insurer going bankrupt—could make the portfolio unprofitable. Most investors limit the number of large policies they buy to control this risk.
Low Premiums

When deciding how much to offer you for your policy, life settlement providers factor in the premiums they expect to pay before your policy delivers a benefit. To add safety to their calculations, they also may include a cushion. A life settlement provider may assume, for example, that it will pay your policy’s premiums for the insured’s median life expectancy plus one year, or that it will pay premiums for the 85th percentile of the insured’s life expectancy. Because the cost of premiums is priced into a life settlement provider’s calculations, you will receive a better offer for a policy with low premiums than for a similar policy with higher premiums.

The absolute cost of your premiums is not important; rather, the life settlement provider will consider what percentage of the policy’s face value it will have to pay in premiums over the course of a year. The longer the insured’s life expectancy, the more important this percentage becomes. For an insured with a life expectancy of ten years or more, such as a man in good health in his early 70s, the annual cost of the premiums should be 4 percent of the policy’s benefit or less. For insureds with shorter life expectancies, higher premiums are acceptable, but policies with annual premium payments that exceed 8 percent to 10 percent of the policy’s face value will find it difficult to get a favorable settlement offer.

One very important thing to understand about premiums is that the premiums you are currently paying may not be the premiums that an investor will pay. An investor will pay the absolute minimum required to keep the policy in force until the death of the insured.
If, for example, you are paying sufficient premiums so that cash value is rising in a universal life policy, an investor will pay less premiums so that the cash value will decrease to minimum levels. On the other hand, if you have a universal life policy which has cost of insurance charges that have started to exceed your premium payments, an investor will increase payments so that the policy will not lapse in the future. Premium payments for a term policy are a special case. Recall that term policies are almost always converted into permanent policies before being sold. It is the cost of premiums for the converted permanent policy, not the premiums you are currently paying for the term policy, that are relevant in a life settlement.

In some situations, your premium payments may be zero. A universal life or whole insurance policy, for example, may be “paid up.” This means that the policy has accumulated sufficient cash value so that the interest produced pays for the cost of the insurance. Your premiums may also be zero if you are disabled and the policy has a disability waiver. Obviously, these policies are very desirable for life settlement providers because premium payments are a major expense to them. You may receive a large offer for a policy with no premium payments.

However, having a policy with no premium payments also eliminates a major advantage to you of entering a life settlement transaction. In a typical life settlement, you gain both by receiving immediate cash and being relieved of the burden of future premium payments. If you are not making any premium payments, your only gain from the transaction is immediate cash. A life settlement on a
zero-premium policy is simply a choice between cash now or cash at the insured’s death. In Chapter Eight, we will explain a simple way to calculate whether you are getting a reasonable offer on a zero-premium policy.

**Outstanding Loans**

Many people take out loans against the value of their life insurance policies. A loan is often an excellent way to access the cash in a policy while preserving the death benefit and avoiding taxes. Though it is often very convenient, a loan against a life insurance policy must be paid back like any other loan. If you settle your life insurance policy, the life settlement provider will deduct enough money from the settlement to completely pay off your loans against the policy. Every dollar in loans is a dollar that will be deducted from your cash offer. For this reason, policies that are collateral for large loans will receive lower offers.

**Insurance Company Rating**

The financial strength of insurance companies varies widely. Because life settlement providers do not expect to receive a policy’s benefit for at least several years, they prefer to buy policies from insurers that have strong and stable long-term finances. Although it is rare for an insurance company to fail, life settlement providers cannot ignore the possibility that a weaker insurer will become unable to fully pay a policy’s benefit. Consequently, you will receive slightly larger offers for policies from a financially strong insurer, and smaller offers (or none at all) for policies from weaker insurers.
Companies known as rating agencies grade the financial security of insurance companies. The two most commonly used rating agencies are the A.M. Best Company and Standard and Poor’s. (Weiss Research, Fitch, and Moody’s are also commonly used.) A.M. Best’s grades range from A++ (very superior) to F (in liquidation). Standard and Poor’s ratings range from AAA (extremely strong) to CC (extremely weak). Life settlement providers will usually not buy policies from insurers rated less than B+ by A.M. Best or BBB- by Standard and Poor’s. You can look up your insurance company’s rating on its Web site.

**Interest Rates**

Interest rates in the economy can have a powerful influence on life settlement transactions. In a life settlement, the provider gives up money now (your settlement payment) to receive a larger sum of money later (the policy’s death benefit). Money now is worth more than the same amount of money later, so the provider must “discount” the payment to you to reflect the time it expects to pass before it receives the policy’s benefit. The discount rate depends on interest rates. Generally, higher interest rates mean that you will receive a smaller offer for your life policy. This is because when interest rates are high, providers (and the investors that fund them) have other investment options that will yield a good return with little risk—no one, for example, would invest in a life settlement transaction that they expect to generate a lower return than the interest rate on a U.S. Treasury bond, which is virtually risk free. On the other hand, when interest rates are low, you will receive better
offers for a life policy. Quite fortunately, low interest rates often cause life insurance policies to perform poorly and build up little cash value. That means that interest rates may boost the settlement value of policy just when you are interested in selling it because of poor performance.

**Premium Financing**

Before we move on to the next chapter, let’s discuss one more item that can radically alter the marketability of a policy. If you are unwilling or unable to pay the premiums of your policy, you may have turned to special loans, known as premium financing, to make these payments. Most providers will not consider policies that are premium financed, no matter how otherwise attractive. These providers believe that there are simply too many legal entanglements associated with these arrangements to consider investing in them. Other providers will consider buying premium-financed policies on a case-by-case basis, but only if the policy passes a rigorous anti-fraud review. In particular, you may be required to demonstrate that you purchased a policy for legitimate insurance protection or estate planning goals, rather than with the intent to sell it in a life settlement. Providers are particularly skeptical of policies that are financed with “non-recourse” loans which promise that you will not be held personally liable if you cannot pay back the loan. These loans are often used in illegal STOLI schemes. Before you enter a premium financing arrangement, carefully consider its effect on the marketability of your policy.
Chapter 4

Reasons to Settle Your Life Insurance Policy

Whether to settle your life insurance policy is a personal choice that only you can make. Just because your policy is eligible for a settlement does not mean that selling it is a good idea. No matter how much money your policy may fetch, you must carefully evaluate the pros and cons of a life settlement. This chapter is about reasons why many people choose to sell their life policies. Read it carefully, but no matter how well these reasons seem to apply to your situation, do not make up your mind without reading the next chapter, which is about reasons not to sell your policy.

So why might you want to sell your life insurance policy? The major reasons for settling a policy fall within in the following categories:

- Changes in life circumstances,
- New financial needs,
- Inadequate policy performance, and
- Changes in financial or estate planning.
In the remainder of this chapter, we will examine each of these categories in detail.

Changes in Life Circumstances

Although some people obtain life insurance purely as a general investment, it is more likely that you were motivated to obtain life insurance—at least in part—by a desire to provide financial security for someone in the event of your death. According to surveys, almost 80 percent of life insurance is bought primarily for income protection. What happens, however, if your life circumstances change significantly? You may find yourself paying for income protection that no one needs.

One of the most common reasons that a life insurance policy may not serve your needs is that the beneficiary has died. Perhaps, for example, you purchased insurance on your own life to protect your spouse or child in the event of your death, but your loved one passed away first. You can always designate another beneficiary, but often there is no one else who truly needs financial protection after your death. Under such circumstances, there is no reason to pay for insurance, and you should treat your life insurance policy just like any other investment. Ask yourself if you would rather continue paying premiums so that you can direct the disposal of a larger sum of money at your death (to a charity or relative, for example), or if you would prefer to have a smaller sum of money now with no future obligation to pay premiums. If you think you would rather have
the smaller sum now, you should consider seeking life settlement offers on your policy.

Another common change in life circumstances is a divorce from your spouse. In a divorce, a life insurance policy is often considered marital property, but it can be difficult to allocate the obligations and benefit of a policy. Moreover, many people find it psychologically distressing to think of an ex-spouse profiting from their death. Turning the policy into easily divisible cash through a life settlement may be a simple solution to an otherwise complicated and contentious problem. In other cases, you may have had a falling out with a partner, child, relative, or other loved one. Once again, in these circumstances you can always choose another beneficiary. But if no one needs protection in the event of your death, a life insurance policy may not be a good choice. If you would rather have cash than a death benefit, you should consider a life settlement.

Unfortunate events are not the only occurrences that make your life insurance policy unwanted. A positive change in the financial circumstances of your beneficiary can also render a life policy unnecessary. For example, children who have been named beneficiaries may have achieved financial independence, and might no longer be economically affected by your death. Or you may have acquired sufficient wealth to make the protection of life insurance unnecessary. Many people simply outlive the usefulness of life insurance because, after a lifetime of saving and planning, they have paid for
all their major expenses. A life settlement may be a good way to turn a policy that is no longer needed into cash.

All of the changes in life circumstances that we have discussed may make your life insurance policy unnecessary. But even when you know your life circumstances have changed, it can be tempting to continue the status quo and keep paying premiums. After all, you bought that insurance policy for a reason, so you had better hang onto it, right? Don’t fall into that trap! If you no longer need insurance protection, don’t pay for it. An insurance policy that serves no protective purpose is just an investment. Think of it a like a stock, bond, or savings account. If you aren’t satisfied with the returns, get rid of it.

In other cases, you may still desire life insurance, but of a different type or value than your current policy. For example, if you purchased a high face value permanent policy to pay estate taxes, and then estate tax law changes reduced your potential liability, it might make sense to get a smaller policy focused on other needs. Or you have bought a policy for income protection for your spouse, but then retired from work. With no need for income protection, a second-to-die policy might be more appropriate. There is often no way to efficiently convert a policy directly into a more suitable form. A life settlement to generate cash for a new policy may be your best bet.

There are many other changes in life circumstances that may make a life settlement a good option. As we mentioned in Chapter
One, the vast majority of life insurance policies never pay a death benefit. We believe the primary reason why most people let their insurance policies lapse is that the policy has outlived its usefulness due to changes in the circumstances of the owner or beneficiaries. If you face such a situation, you should consider a life settlement.

Financial Need

Sometimes satisfying an urgent financial need is more important than receiving a future death benefit. A life settlement can be a source of cash when you lack liquid assets. Although you should always explore alternatives before selling your life policy, there are many situations in which you may prefer to lose a future death benefit rather than sell other assets, take out a loan, or reduce your standard of living. The cash from a life settlement can be used to meet any lawful financial need.

As you may recall from Chapter Two, the life settlement industry originated through viatical settlements that funded immediate financial needs, primarily for health care. As you grow older, you may find that your health care costs are greater than you anticipated. Medicare may not pay for all your medical expenses or for the quality of care you desire. Many retirees with employer-provided health benefits also discover that these benefits are subject to reduction or cancellation at any time, leaving them with unexpected medical costs. Long-term care (such as assisted living homes and nursing homes) can also cause major expenses. Many senior citizens are
dismayed to find that the circumstances under which Medicare will pay for long-term care—and the type and quality of care for which it will pay—are limited. A life settlement can provide the cash to provide for quality health care or long-term care for yourself or a loved one.

A life settlement can also provide cash for other family emergencies. Life settlements have been used to avoid foreclosures, and to save family businesses. (The sale of a key man policy can be an especially attractive way to provide cash for a family business.) The proceeds from the sale of a life policy can also be used to deal with financial problems faced by your children or other loved ones. This may be particularly appropriate if they are the beneficiary of the policy being settled.

If you have the misfortune of entering bankruptcy, you may be required to sell a life policy that you own. Although the treatment of life insurance and cash value built up within a life insurance policy varies from state to state, most states allow you to exempt only a portion of the cash value of your life insurance from bankruptcy creditors. A bankruptcy trustee may demand that you settle your policy to maximize the amount that your creditors receive. Moreover, the knowledge that your life policy may not be fully exempt in bankruptcy may affect your strategy. Generating cash from a life policy which cannot be fully exempted may allow you to get a better deal in bankruptcy, or may even allow you to avoid bankruptcy entirely.
Poor Performance

While a change in life circumstances or an unexpected financial need may lead you to seek a life settlement, it is equally common to sell a life insurance policy because of its poor performance. Insurers and their agents often promise the purchasers of whole or universal policies that their policies will pay healthy dividends and build up cash value. Frequently, however, some or all of these dividends are not guaranteed. If your insurer’s investments perform poorly, your policy dividends—and the cash value of your policy—may be much less than expected. Cost of insurance charges in universal policies may also rise more quickly than projected, and thus decrease the cash value of your policy. As you get older, this can become a serious problem because the cash account value of your policy was expected to generate income to pay some or all of the cost of your life insurance. Instead of enjoying cash withdrawals and loans on the value of your policy, you may find yourself making expensive premium payments just to keep your policy from lapsing.

Poor performance happens for a variety of reasons in the world of life insurance. Any permanent policy is a long-term investment, and the company you thought was rock solid may have become less prudent over the years. In some cases, too, a life insurance agent eager for a sale may have sold you a policy based on overly optimistic projections. Other policies, especially universal policies bought during the 1970s or early 1980s, may simply have fallen victim to a
long-term fall in interest rates. A policy that assumed a continuously high rate of interest may not generate enough income to pay its own premiums when interest rates fall.

Before the creation of a secondary market for life insurance, consumers had few options when premium payments were too high. They could surrender or exchange their policies to extract the cash value (which was often minimal), or let the policies lapse. Either way, the consumers were faced with the knowledge that years of premium payments had produced little or no return. Today, a life settlement is a third option if you face excessive premium payments. A life settlement can allow you to extract the true economic worth of your policy—instead of a sum determined by your insurance contract—while relieving you of premium payments.

Even if you can comfortably afford the premium payments on a poorly performing policy, you may simply view it as a bad investment. If you have expressed your concerns to your insurance agent, he or she has probably mentioned the possibility of a “1035 exchange.” This transaction, which is named after the Internal Revenue Code section that permits it, transfers the cash value of your policy (and the tax basis) to a new life policy. In a 1035 exchange, you cannot receive any cash (without recognizing taxable gain) and the insured must remain the same—even a change to a survivorship (last-to-die) policy is not allowed. These restrictions limit the flexibility of 1035 exchanges, but the advantage is that you pay no immediate taxes.
Traditional 1035 exchanges are pure swaps of one life policy for another. Often a policyholder will exchange an outdated policy for another from the same insurance company—this is called an “internal” exchange. In other cases, a policy owner will order an insurance company to send the cash surrender value of a policy directly to a different insurer to fund a new policy—this is called an “external” exchange. In either case, a traditional 1035 exchange will leave you, at best, with a new policy with the same cash value as before. In fact, the cash value may be less after commissions, surrender charges, and other fees are paid.

Fortunately, in these situations, a life settlement can be especially useful. A life settlement will generate more cash than the surrender value of a policy, and can be invested as you please. Some people use the cash to buy a new policy (sometimes a single-premium policy that is fully paid in one installment) with more favorable terms. This is especially useful with older policies that may lack the features and efficiencies of newer policies. Other policy owners use the cash from a life settlement to buy an annuity, either to generate retirement income or to finance the premiums on a newer, more efficient life insurance policy. Still others choose to invest in the stock market or other non-insurance investment vehicles. Because a life settlement generates cash, it offers you total flexibility to invest as you choose.
A life settlement can also be surprisingly tax efficient. If you were considering a 1035 exchange, it’s usually because you have a high basis in the policy (that is, you’ve paid a lot in premiums over the years). Since the cash received from a life settlement is generally not taxable up to the basis of the policy, you may lose little or nothing to taxes through a life settlement. (For more information about the tax treatment of life settlements, see Appendix B.) Because a life settlement generates cash, it can be used to purchase anything, and thus opens the door to a number of sophisticated tax reduction strategies.

Another possibility is a partial settlement in which you sell your policy but keep part of the death benefit by being designated an irrevocable beneficiary of a specified sum by the new owner. This approach appears to be gaining popularity; however, it does have one important drawback. While it will relieve you of future premium payments, you will not receive your death benefit unless the new owner continues to pay the policy premiums. Thus, you are exposed to the purchaser’s credit risk. Do not consider such an arrangement unless the purchaser has a proven history of financial strength.

Change in Estate or Financial Planning

Life insurance is an important part of most financial and estate plans, often for tax reasons. But just as life circumstances and immediate financial needs can change, so, too, can financial and estate plans. Tax laws, your tax situation, and your personal preferences
can undergo major changes over the years. Even a good policy that was prudently selected in the past may become inappropriate during the long lifespan that is typical of policies purchased for retirement and estate planning purposes.

As you have probably observed, Congress is not shy about changing tax laws. A change in the tax treatment of life insurance or estates can significantly alter your ideal plan. As this book is being written, estate taxes are scheduled to be eliminated in 2010, but then be reinstated with a low exemption ($1 million) and high rates (up to 55 percent) in 2011. What will happen over the next two years? No one knows at present, but a change in the exemption, the rates, or both is highly likely. If the exemption stays at a high level, many life insurance policies bought to pay estate taxes will become unneeded. Life settlements are a great tool to convert such unneeded policies into cash. A life settlement be also be used to reduce taxes by removing a life insurance policy from an estate, or to generate cash that can be given to charity for an immediate deduction.

Charitable giving, whether or not it is motivated at all by tax considerations, is often the inspiration for a life settlement. Many people name charities as the beneficiaries of their life policies, but this is not always the ideal giving strategy for either party. A charity that is in financial need may prefer to have money now rather than later. Or you may simply prefer to see your money at work before you pass away, perhaps to take part in an important project, or to
create a memorial to a loved one. A life settlement can provide immediate cash for charity while relieving you of the burden of premium payments.

Finally, a life settlement can help you gain flexibility in financial planning and realize life-long goals. Life settlements are often used to prepare for retirement, to take a long-desired vacation, or to provide cash for a new house or other property. People have used life settlements to send grandchildren to college, or to help relatives start a business. If your goals can be met by cash instead of a future death benefit, a life settlement may be the best option.
Reasons NOT To Settle
Your Life Policy

You probably found at least one reason in the last chapter to sell your life policy—after all, who can’t think of a use for cash? While more money and fewer premium payments may sound appealing, there are also many reasons why you might not want to enter into a life settlement. Since you can’t make an informed decision without knowing both the pros and cons of a transaction, this chapter will present a number of circumstances that can make a life settlement inadvisable.

No Clear Plans for Cash

The most fundamental (and often overlooked) reason not to sell your policy is that you have no immediate needs or clear plans for the money. Except in rare circumstances, such as if your state is about to impose new and burdensome restrictions on life settlements, a life settlement is not a once-in-a-lifetime opportunity. There are no special deals in the life settlements market. Interest rates, investor demand, and other factors may drive settlement values up or down,
but the price range of a life settlement is fundamentally constrained by two factors. No legitimate investor will bid less than the cash surrender value of the policy, and no investor will offer more than the face value of its death benefit. Anyone who tells you that you need to apply now for a life settlement because an unusually high settlement offer is only available for a limited time is a snake-oil salesman. If you ever fear that procrastination will cost you financially, remember that as your life expectancy decreases through aging, the life settlement value of your policy will likely increase. A life settlement should always be driven by your needs and desires, not pressure or fear. If you decide not to sell your policy, you can always change your mind later.

It is important to consider that a life settlement offer will always be less than your policy’s actuarial value (i.e., its fair value to an investor, all things being equal)—otherwise life settlement providers would not make any profit. For a life settlement transaction to be a good deal for you, it must result in some kind of special benefit for you, such as enabling you to fulfill a dream or obligation while still alive, or relieving you of burdensome premium payments or tax obligations (e.g., gift taxes on premium payments for a policy held in a trust, or estate taxes on a death benefit). Don’t enter a life settlement just to put cash into a checking account. Your personal needs and goals may have a limited window of opportunity, but a life settlement transaction does not.

With the above considerations in mind, our recommendation is that you should not even seek offers for a life settlement unless you
have a strong desire to terminate your policy or a clear plan for the money from a life settlement. If you enter the life settlement process without good cause, you may be tempted to accept a good offer, even if policy retention would better suit your needs. Also, seeking offers for a life settlement is not something you can do an unlimited number of times. There are a limited number of investors in the life settlement world, and most will not consider making an offer for a policy that they have considered recently (e.g., within the last year). In the authors’ experience, investors also tend to bid less on policies that are repeatedly shopped—probably because they doubt the owner is serious. Seeking a life settlement offer just to see what your policy is worth may leave you unable to get a good offer when you need it most. The easiest way to avoid these problems is simply not to begin the life settlement process unless you have a clear desire to get rid of your policy and a clear plan for the settlement proceeds.

Personal Circumstances

Knowing that a life settlement will continue to be an option if it is possible now, you should focus your attention on your personal circumstances. Some circumstances provide strong reasons not to sell your policy.

A leading reason that many people who apply for a life settlement decide not to accept an offer is that they discover they still need some insurance protection, but cannot obtain replacement insurance. No financial product is a true substitute for insurance. If you need insurance, make sure that you can get suitable replacement coverage before you sell your policy. If you are uninsurable because of a serious
medical condition, for example, you should think carefully about your potential need for insurance before selling. For older people, it is usually much easier to sell or surrender a policy than it is to obtain new coverage on favorable terms. Consequently, if you still need insurance and are uncertain about whether selling your policy is right at this time, you should not do it. (In some cases it may be possible to “split” your policy, keeping some insurance protection and selling the rest for cash. We’ll talk more about this later.)

You should also consider the fact that insurance companies will only write so much life insurance on any given person’s life. This insurability limit depends on a person’s wealth and obligations. Because life insurance sold in a life settlement remains in force, it counts against the insured’s limit. Thus, entering into a life settlement can make it difficult to obtain more life insurance later.

A life settlement also is not a good idea if you are insolvent (that is, bankrupt or nearly bankrupt) and do not plan to use the cash to pay creditors. Once a life settlement is completed, the cash you receive is treated like any other asset you possess. Creditors can have the proceeds of a life settlement seized just like other property. Similarly, if you are receiving Medicaid, Social Security disability payments (not Social Security retirement benefits), or other government benefits that are tested for income or assets, the government may be able to take the proceeds of a life settlement or cut off your benefits, because that money will be considered an asset. If you are unsure about whether a life settlement will affect your benefits, contact the appropriate government agency or consult a lawyer for more information.
Medicare eligibility is not affected

Eligibility for Medicare is not affected by a life settlement. However, a life settlement could cause you to pay larger premiums for Medicare Part B in a future year. This is because a life settlement is considered income, and Medicare Part B premiums increase as your income goes up past a certain threshold. (As of 2008, this threshold is $82,000 for a single income tax return or $164,000 for a joint return.) This effect, however, is delayed and fortunately temporary, because premiums are calculated based on your income from two years ago.

This is all a bit complicated, so let’s see how this works through a concrete example. Sally has a fixed income of $32,000 per year from a pension, and sells her life policy for $300,000 in 2006. (Not bad!) The basis of her policy (the amount she is deemed to have paid for it) is $100,000, so she realizes $200,000 in income from the settlement. (We discuss the tax treatment of life settlements in detail in Appendix B.) Her 2006 income is thus $232,000—that’s $200,000 in income from the life settlement plus her fixed income of $32,000. In 2008, Medicare sees that her income jumped in 2006 (remember, Medicare looks two years back), and raises her monthly Part B premiums from $96.40 per month to $238.40 per month, which is the maximum premium permitted by law. Sally isn’t happy about that, since the increase will cost her about $1700 in 2008! Fortunately, in 2007, Sally’s income returned to normal. In 2009, Medicare will see that her 2007 income was $32,000, and reduce her premiums based on that income level.

The bottom line is that a life settlement might cause your Medicare Part B premiums to increase two years down the road, but the increase will only last for one year, and will rarely (if ever) be large enough to make a life settlement a bad deal. If you sell your policy for enough money to significantly affect your Medicare premiums, you should have plenty of cash to pay the extra amount for 12 months.
Social Security, Pensions, Etc.

A life settlement will not affect your eligibility for retirement benefits from Social Security, private pensions, annuities, or similar income sources. A life settlement is a one-time payment to you that is considered an investment gain for most purposes. Social Security retirement benefits and pension payments are payments that you are entitled to as a right—they cannot be reduced because you temporarily have additional investment income. Even early retirement benefits from Social Security cannot be reduced because of a life settlement because such benefits are only reduced for income that you earn through work.

Social Security disability payments, however, may be temporarily reduced when you have too much income. This is rarely a problem in a life settlement because the policy owner is usually older than the Social Security normal retirement age (age 65 to 67, depending on the year of your birth). Once you reach your normal retirement age, Social Security disability benefits become Social Security retirement benefits, and are no longer means-tested.

Before you seek a life settlement, you should also consider the desires of the insured and the policy’s beneficiaries. You cannot sell a policy without the cooperation of the insured—they can block any sale by refusing to sign the necessary paperwork. A beneficiary cannot block a sale unless you have specifically designated him or her as an irrevocable beneficiary. But a former beneficiary can still get upset about the sale of a policy, even if they don’t really need the money. Money sometimes causes otherwise rational people to do strange things. Be sure to consider whether selling your policy will cause ill will among family and other loved ones, and plan accordingly.
In summary, carefully consider the impact a life settlement will have on your personal circumstances before selling a policy. Don’t sell if you need the future death benefit more than current cash, or if the sale would create personal problems between you and the people you care about.

**Affordable Premiums**

You don’t need to be in dire straits to sell your life policy. In fact, most people who do sell are in good financial shape. But if you can easily afford the premiums you are paying, you don’t need to rush into a settlement. Sit back, relax, and consider the alternatives at your leisure. You may still decide to sell if your policy is performing poorly or otherwise not meeting your needs—just don’t let anyone pressure you into a bad choice.

**Poor Candidate for Settlement**

Just because you are eligible for a life settlement doesn’t mean you will be offered a large percentage of your policy’s face value (death benefit). As we discussed in Chapter Three, the amount of a life settlement offer depends on several factors, including life expectancy, policy type, and policy value. Some factors may make you a relatively poor candidate for a life settlement. If this happens, keep in mind that you can always wait and sell your policy later.

One of the most important factors that life settlement providers take into account when making offers for policies is the insured’s life expectancy. If the insured is relatively young and healthy (e.g.,
65 with no health problems), he or she will probably have a long life expectancy and receive a relatively small percentage of the policy’s face value. That an offer is relatively small is not a clear cut reason to avoid selling. After all, if a life settlement provider makes a small offer because it thinks it will have to wait a long time for the policy to pay a benefit, it is also likely that your beneficiary will have to wait a long time to see any benefit. You probably don’t want to wait for the money any more than the life settlement provider does, but keep in mind that offers for your policy will probably increase, not decrease, as the insured ages. This is because an older insured has a shorter life expectancy, and therefore a more valuable policy. So, once again, our advice boils down to this: Don’t rush into a settlement. Take your time, and remember that you can always seek offers down the road instead of now.

**More Attractive Alternatives**

A life settlement isn’t the only way to deal with a policy that isn’t meeting your needs, or that you can’t afford. A number of alternatives exist beyond simply surrendering your policy. First of all, make sure that the policy itself cannot help you. If you are comfortable with the performance of your permanent life policy, be sure to consider whether a policy loan (or, less commonly, a withdrawal) makes sense. A loan from the cash value of your policy could allow you to enjoy some of its accumulated value while keeping it in force. You will be charged interest for the loan, but the cash value of your policy can also be used to pay this. Be aware, however,
that loans and interest can add up very quickly, and can cause your policy to terminate if they use up all the policy’s cash value. (Such a termination can also cause a tax catastrophe: If your loans exceed the premiums you paid, you will have to pay taxes on the excess!) Think things through before you take out a loan, but do not disregard this option.

Also, if you are thinking of selling your policy because of costs associated with health problems or long-term care, be sure to check your policy for provisions that can help you. Some policies have morbidity provisions that provide money for specified illnesses or nursing home care. In addition, some policies waive premiums if you are disabled. Ask your agent or insurance company for details.

Accelerated death benefits are another alternative to a life settlement that you may have heard about. Accelerated death benefits are provisions of a policy (sometimes in a rider) that permit you to tap some of the benefit if the insured has a very short life expectancy—typically one year or less. Basically, they are an advance on a policy’s death benefit. Accelerated death benefits are advantageous because you retain ownership of the policy, and they are often a good alternative to a viatical settlement. They are, however, useless to someone seeking a life settlement because they are typically not available unless the insured has a life expectancy of one year or less.

Assuming that a policy loan, withdrawal, or accelerated death benefit is impossible or unrealistic, premium financing is one alter-
native that you should consider if you truly want to keep your policy but are having difficulty making premium payments. As the name suggests, premium financing involves a third-party lender making some or all of your premium payments for you. Naturally, the lender charges interest for this loan, which you typically would pay as it accrues. The lender will also want collateral for the loan. The death benefit of the policy and its cash surrender value usually must be pledged to the lender as collateral. If those items are insufficient collateral, you may also have to pledge other assets as well. Premium financing arrangements are complex loans that require very close analysis; we do not recommend entering into one without consulting a lawyer. But they can be useful, especially for estate planning situations in which the policy cannot be sold. Keep in mind, however, that once you enter into a premium financing arrangement, most life settlement providers will not consider buying your policy.

You may also consider loans to pay premiums from sources other than financial institutions. If your life policy is a key part of your estate, your family or beneficiaries may be willing to finance premiums to keep a policy in force. This strategy can make more sense for everyone involved if the policy is given to a family partnership or trust, rather than legally owned by you. These arrangements can ensure that everyone’s expectations are met, as well as potentially being advantageous for tax purposes.

If you have decided that you can’t maintain your policy in its current state, you should consider a 1035 exchange in which your policy is exchanged for another with the same insured. As we dis-
cussed in Chapter Four, this will leave you with a new policy that has no more cash value than before. Compare a potential 1035 exchange side-by-side with a life settlement (in combination with the purchase of replacement insurance, if necessary) to see which is the best deal.

If you have a whole life policy, one popular strategy is to exchange your current policy for a smaller “paid up” policy. While this will typically preserve only a small fraction of the policy’s death benefit, a true “paid up” policy will relieve you of all future premium payments. If income, rather than life insurance, is needed, you should also consider exchanging a policy for an annuity that is “rated” for the insured’s health. If the insured is in poor health, this annuity may be very valuable.

In situations in which you want or need to retain some insurance protection, you should also consider whether you want to sell all of your life insurance or just a portion of it. If you have multiple policies, you may wish to sell some but not others. Even if you have only one policy, it may be possible to sell the policy and retain a portion of the death benefit. For example, some policies can be split into two smaller policies. You could split a $1 million policy into two $500,000 polices, sell one, and keep the other.

Finally, before you sell your life policy, you should consider whether you can sell or extract value from other assets that you own. For example, reverse mortgages have become a popular method for people to extract value from their homes without immediately sell-
ing them. A reverse mortgage is a loan combined with a commitment to sell your house once you die or leave it. It can be a useful way to generate cash if you do not plan to pass on your house to your heirs. As with any large financial commitment, do not enter into a reverse mortgage without seeking professional advice.
This chapter will help you decide whether a life settlement is possible, practical, and a good choice for you. We’ll go through all of the steps you need to take in a logical and systematic fashion.

**Step One: Gather Your Policy Information**

The first step is to get all the information you can about your life insurance policy. This is a vital action that a surprising number of people skip. But how can you decide whether selling your policy is a good idea (or a bad one) unless you know what the terms of your policy are? The answer, of course, is that you can’t. You need to see the exact terms of your policy and understand how it works before you can make an informed decision. Frequently, once people review their policies, they discover that the terms are quite different than they expected.

Fortunately, obtaining the information you will need about your life insurance policy is very easy. You will most likely have to call your insurance company for at least some of the information, but
don’t worry about these phone calls. Insurance companies are required by law to give you the information that you will need. You will not have to tell them why you want it if you do not want to. (If you feel obligated to answer a question about why you want information, we suggest telling them—quite truthfully—that you are doing some financial planning.)

The first item you will need is an actual copy of your insurance policy. You may have this in your files, or you may need to call to get it from your insurance company or agent. Whichever the case, make sure that the document you have is your actual policy. Frequently, people mistake a certificate of coverage or a summary of their policy for the actual policy. An insurance policy is a complicated legal document with defined terms and lengthy provisions, as well as a copy of the application that you filled out when initially signing up for the insurance. Usually, it also has riders, amendments, and other documents attached which alter the terms of the basic policy, sometimes drastically. If you are not certain that you have an up-to-date and complete copy of your policy (and not a sample or specimen policy, but your policy), call your insurance company or agent. Just ask for a complete copy of your policy document, and they will mail it to you.

Second, you will need an “in-force ledger” or “in-force illustration” of how your policy works through age 95 or 100. An in-force ledger is simply an example of how your policy could work as the insured ages. Usually it is a large table of numbers showing the premiums you pay, the cash value of your policy, and other informa-
tion. Unless you have been doing some recent financial planning, you probably don’t have a current copy of an in-force ledger. Once again, just call your insurance company or agent. Ask for an in-force ledger through age 100 for your policy. If your policy is a term policy, you should also ask the insurance company for the last date on which it can be converted, and a conversion illustration showing the term policy converted into a universal life policy.

Third, you will need information about any loans or investments related to your policy. Remember, any loan taken out against your policy must be repaid before the policy can be sold. If you are uncertain about whether there are any outstanding loans, call—you guessed it—your insurance company. If you have a variable life insurance policy (i.e., a policy in which the returns on your cash account vary according to different investments), you will need to know what your policy is invested in, and what the other options are. If that is the case, you can get this information when you call your insurance company.

Fourth, you will need a copy of any trust that holds your policy. Most policies are not held in a trust, so this probably does not apply to you. If your policy is in a trust, the policy will list the trust or the trustee as the owner. You may need to contact the trustee to get a copy of the trust document.

Gathering all the information above probably sounds like a lot of work, but don’t worry; most people can order all the information they need with one call to their insurance company or agent.
Appendix F of this book contains a sample letter to your insurance company requesting everything you need. In the unlikely event that you have trouble, remember that you are legally entitled to all the information discussed above. Do not let an insurance agent or company tell you that you do not need an item or cannot have it.

**Step Two: Review Your Policy**

Once you have gathered all the information in Step One, sit down and review it carefully. Don’t worry about understanding every legal detail of your policy; rather, concentrate on the basics. Who is the owner of the policy? Who is the beneficiary? What is the benefit (face value) of the policy? How much are the premiums? Are the premiums level, or do they increase over the years?

Be certain that you understand what type of policy you have. Remember, a term policy is a policy that expires after a certain number of years. Permanent policies, such as whole life or universal life, do not expire and have a cash account. If you have a term policy, note how long the term is, whether there is a conversion right, and how long you have to exercise the conversion right. If you have a whole or universal policy, see what the value of the cash account is. Figure out what the return or dividend on the cash account is, and how it is determined. Is the return fixed and guaranteed? Is it dependent on the performance of the insurance company or investments made by the policy? Is there any minimum guaranteed return?
If you have a universal policy, the most important thing to look at is the in-force illustration. Reading an in-force illustration can be an overwhelming experience—it is essentially a large spreadsheet of numbers—but it is manageable if you understand how it is organized. The horizontal rows in an in-force illustration represent different periods of time, usually years. As you move farther down the illustration, you are moving farther into the future. The vertical columns give information for each year. Usually there are two sets of columns, one for the policy’s predicted performance and another for its guaranteed performance. Be sure to consider both.

For both the predicted and guaranteed projections, one column in the illustration always shows the “outlay,” which is the premiums that you are projected to pay for that year. Another column shows the policy’s projected account value, and yet another shows the policy’s death benefit. Look carefully at the premiums and ensure that they are not projected to rise above the level you wish to pay. Then look at the account value. Is it rising as your policy builds up cash value, or is it shrinking as charges drain your policy? Finally, and most importantly, look at the death benefit. Is it constant, or is it collapsing to zero at some point? If you see a zero death benefit, that means that your policy is projected to lapse in the future. Your beneficiary will not receive any benefit if that happens, so you should be concerned if lapse is a possibility.

Once you have figured out the basics of how the policy works, think about how the policy fits into your overall financial plan. Most importantly, think about whether the benefit you expect to receive
is worth the premiums you expect to pay. The chief benefit of any life insurance policy is the death benefit, the money that is paid upon the insured’s death. Is this benefit needed and desired? Whole and universal life policies also have cash accounts from which you typically may take loans or make withdrawals. Are loans from your policy’s cash account part of your financial plan? Is the possibility of a loan worth the premiums you will continue to pay? (Do not forget that loans accrue interest that can rapidly devour a policy’s death benefit.)

When looking at premiums, be sure to consider whether the premiums are fixed (as is common in term and whole life policies) or whether they increase each year (as with universal life policies). Do not forget that the premiums for universal life policies are expected to be partially or completely paid for by returns on the policy’s cash account. If these returns are not guaranteed, however, premiums will have to be paid for by deductions from the cash value account or by you. Keep this in mind if the investment returns assumed by your policy’s in-force ledger seem overly optimistic.
Step Three: Determine Whether Your Policy May Be Eligible for a Settlement

Complete the worksheet by answering yes or no to each question.

*Worksheet One*

<table>
<thead>
<tr>
<th>Question</th>
<th>Answer</th>
</tr>
</thead>
<tbody>
<tr>
<td>Are you the legal owner of the policy?</td>
<td></td>
</tr>
<tr>
<td>Is the insured willing to release his or health information?</td>
<td></td>
</tr>
<tr>
<td>Is your policy at least two years old (i.e., is it incontestable?)</td>
<td></td>
</tr>
<tr>
<td>Is your policy a permanent policy (e.g., whole or universal) or a term policy that can be converted into a permanent policy?</td>
<td></td>
</tr>
</tbody>
</table>

If you answered no to any of the questions, you cannot proceed with a life settlement unless the problem is resolved.
Worksheet Two

Complete this worksheet to determine if a policy that has passed Worksheet One is a possible candidate for settlement. Unless the instructions specify otherwise, add the points from each question and look up the total on the Total Score table to determine the appropriate action.

Qualifying Worksheet

Insured Age & Sex: ______________________

Policy Face Value (i.e., death benefit): _____________________

Cash Surrender Value: _____________________

Premiums (annually):_______________________

Loans: __________________________________________

<table>
<thead>
<tr>
<th>Age and Sex</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Male age 65 or less</td>
<td>Warning: Unlikely candidate unless in poor health</td>
</tr>
<tr>
<td>Female age 70 or less</td>
<td></td>
</tr>
<tr>
<td>Male age 66 – 70 / Female age 71 – 75</td>
<td>□ 0 points</td>
</tr>
<tr>
<td>Male age 71 – 75 / Female age 76 – 80</td>
<td>□ 2 points</td>
</tr>
<tr>
<td>Male age 76 – 80 / Female age 81 – 85</td>
<td>□ 4 points</td>
</tr>
<tr>
<td>Male age 81 – 85 / Female age 86 – 90</td>
<td>□ 6 points</td>
</tr>
<tr>
<td>Male age 86+ / Female age 91+</td>
<td>□ 8 points</td>
</tr>
</tbody>
</table>
### Health

<table>
<thead>
<tr>
<th>Health</th>
<th>Points</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exceptional health for age</td>
<td>□ 0 points</td>
</tr>
<tr>
<td>Normal health for age</td>
<td>□ 1 point</td>
</tr>
<tr>
<td>Below average health with minor conditions</td>
<td>□ 2 points</td>
</tr>
<tr>
<td>Poor health with serious conditions</td>
<td>□ 3 points</td>
</tr>
<tr>
<td>Terminal illness</td>
<td>Possible vatical settlement; call a broker to discuss</td>
</tr>
</tbody>
</table>

Note: If the policy insures two people and pays only the death of both, use the insured whose health and age generates the lower point value of the two.

### Policy Category

<table>
<thead>
<tr>
<th>Policy Category</th>
<th>Points</th>
</tr>
</thead>
<tbody>
<tr>
<td>Whole</td>
<td>□ 0 points</td>
</tr>
<tr>
<td>Universal</td>
<td>□ 3 points</td>
</tr>
<tr>
<td>Convertible Term</td>
<td>□ 2 point</td>
</tr>
<tr>
<td>Variable Universal</td>
<td>□ 1 point</td>
</tr>
</tbody>
</table>

### Cash Surrender Value

<table>
<thead>
<tr>
<th>Cash Surrender Value</th>
<th>Points</th>
</tr>
</thead>
<tbody>
<tr>
<td>50+% of face value (i.e., death benefit)</td>
<td>Stop: Unlikely to be settled</td>
</tr>
<tr>
<td>30+% of face</td>
<td>□ 0 points</td>
</tr>
<tr>
<td>20+% to 30% of face</td>
<td>□ 1 points</td>
</tr>
<tr>
<td>10+% to 20% of face</td>
<td>□ 2 points</td>
</tr>
<tr>
<td>10% of face or less</td>
<td>□ 3 points</td>
</tr>
</tbody>
</table>

Note: Term policies have no cash value.
### Face Value Minus Outstanding Loans

<table>
<thead>
<tr>
<th>Amount Range</th>
<th>Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than $50,000</td>
<td>Stop: Cannot be settled</td>
</tr>
<tr>
<td>$50,000 to $249,999</td>
<td>0 points</td>
</tr>
<tr>
<td>$250,000 to $499,999</td>
<td>1 point</td>
</tr>
<tr>
<td>$500,000 to $999,999</td>
<td>2 points</td>
</tr>
<tr>
<td>$1,000,000+</td>
<td>3 points</td>
</tr>
</tbody>
</table>

### Total Annual Premiums

<table>
<thead>
<tr>
<th>Percentage of Face</th>
<th>Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>4+% of face</td>
<td>0 point</td>
</tr>
<tr>
<td>3+% to 4%</td>
<td>1 point</td>
</tr>
<tr>
<td>2+% to 3% of face</td>
<td>2 points</td>
</tr>
<tr>
<td>1+% to 2% of face</td>
<td>3 points</td>
</tr>
<tr>
<td>1% of face or less, including disability waiver</td>
<td>4 points</td>
</tr>
</tbody>
</table>

Note: Determine the percentage of annual premiums by adding up all the premiums needed to pay the policy for a year, and then dividing by the death benefit. For example, suppose you pay $300 per month for a policy with a $1,000,000 benefit. The annual premiums are 12 months x $300 per month = $3600 per year. $3600/$1,000,000 is 3.6 percent.

For a convertible term policy, the relevant premiums are the premiums you would pay after conversion into a permanent policy. You may need to get a conversion illustration from your insurance company to figure out those premiums. Generally, however, they will be several times more than your payments for the term policy.

### Total Score

<table>
<thead>
<tr>
<th>Score Range</th>
<th>Action</th>
</tr>
</thead>
<tbody>
<tr>
<td>6 or less</td>
<td>Settlement highly unlikely</td>
</tr>
<tr>
<td>7 to 11</td>
<td>Settlement unlikely</td>
</tr>
<tr>
<td>12 to 18</td>
<td>Good candidate</td>
</tr>
<tr>
<td>19 or greater</td>
<td>Exceptional candidate</td>
</tr>
</tbody>
</table>
Step Four: Review Your Motivation for a Settlement

If the worksheet indicates that your policy may be eligible for settlement, review Chapter Four and decide if any of the reasons to sell a policy apply to you. Is there a definite reason to sell your policy? If the answer is “no,” you should not sell your policy. Do you have a plan to use the money you will receive from a settlement? If you don’t, think seriously about whether a settlement is a good idea, and do not proceed further until you have a plan for the money.

Step Five: Look for Potential Problems

Skim over Chapter Five once more and see if any of the reasons not to sell your life policy apply to you. If they do, do not proceed with a settlement unless you can resolve the problem. In particular, if you need replacement insurance, be sure that you can obtain this insurance before you go any further. Find multiple sources for the insurance you need—it is important to have replacement insurance ready to go at the same time that you sell your policy. If you face problems that make a life settlement impractical, take a look at the alternatives to a life settlement in Chapter Five, and see if one could work for you.
Step Six: Consider Obtaining Professional Advice

If a life settlement seems like a good option after you have completed Steps One through Five, you should consider whether you need to talk to your financial planner, accountant, or attorney about a life settlement. If you have tax questions or unusual circumstances that may make a life settlement a bad idea, it may be a good idea to get professional assistance. You may also want to talk with a life insurance agent about alternatives to a life settlement, such as a 1035 exchange for a new policy. Keep in mind, however, that insurance agents get paid commissions for selling you a policy. Unfortunately, this can make some agents overly optimistic about the need for and value of a new policy. Do not rely on the promises of an agent about a policy’s performance unless that performance is guaranteed by the policy.

Step Seven: Keep Reading

If you have decided to move ahead and try to get offers for your policy, you will need to understand how the life settlement process works and how to choose someone to work with. Read Chapter Seven for a description of the parties in a life settlement, their motivations, and the basic life settlement process. Then Read Chapter Eight for information about how to select a life settlement broker and what to expect as you apply for and receive offers on your policy.
Now that you have decided to seek offers for a life settlement, you need to hire a good broker. Before you do that, however, we suggest that you read this chapter to learn more about the parties and processes of a life settlement. This will help you understand what to expect, and what the qualities of a good broker should be. For those who want to cut to the chase, you may skip ahead to Chapter Eight, where we summarize the qualities you should look for in choosing a broker, and how to work with the one you choose.

The Parties

*The Policy Owner*

The policy owner is the person who has legal title to the policy. If you are reading this book, you are most likely the policy owner. Only the policy owner (or someone with a power of attorney for the policy owner) has the power to sell the policy through a life settlement. The policy owner is responsible for choosing a life settlement
broker, evaluating offers, and deciding whether to accept an offer. The policy owner, not a beneficiary of the policy, will receive the proceeds of a life settlement.

**The Insured**

The insured is the person whose life is insured by the policy. You cannot transact a life settlement without the consent of the insured because they will need to sign legal documents to release their medical information. If the insured is incapacitated, you must have a health care power of attorney to close a life settlement.

**The Beneficiaries**

The beneficiaries are the people who would receive a death benefit if the insured died. These people may need to be involved in a life settlement in order to sign releases. Regardless, it is best to keep them informed so that they do not expect to receive a death benefit in the future.

**The Insurance Company**

The insurance company must produce several key documents (which we will discuss later in this chapter) that are necessary to apply for and close a life settlement. You should not expect any help in seeking a life settlement from your insurance company. Some may even try to talk you out of it once they realize you are considering one.
The Insurance Agent

Many people attempt to begin the life settlement process by calling the insurance agent who sold them the policy. Unfortunately, in the opinion of the authors, this is one of the worst mistakes you could make. The vast majority of life insurance agents have little or no accurate knowledge about life settlements, and many are actually forbidden to talk about them by their insurance carriers under pain of dismissal. In addition, very few are licensed to broker life settlements. That said, most insurance agents will not interfere with a life settlement being conducted by a licensed broker, and will usually not try to talk you out of a transaction. Agents may even try to talk you into a transaction involving a term policy—life insurance agents often make large commissions from the conversion of term policies into permanent insurance.

The Life Settlement Providers

A life settlement provider is the company that will make offers for your policy and purchase it if you accept. We do not recommend contacting life settlement providers directly. Instead, work through a life settlement broker to get competitive offers from multiple providers simultaneously.

The Life Settlement Funders

Life settlement providers are primarily conduits for other purchasers. The companies that provide the money and will ultimately own your policy are called funders. They are interested in aggregating large portfolios of policies, and do not (and will not) deal directly with consumers.
The Life Settlement Broker

A life settlement broker is a person or company who seeks offers for your policy from multiple providers. A broker owes fiduciary duties *only to you*. A good broker will work with every reputable provider to get you the highest possible offer for your policy. Brokers almost always work on commission—they only get paid if you accept an offer.

Brokers fall into two categories: “retail” and “wholesale.” Retail brokers are individuals who deal directly with clients. They take applications, communicate offers, and assist with the closing process. Most retail brokers are contracted to work with wholesale brokers that are typically companies or corporations. These wholesale brokerage firms process applications, assemble packages for providers to consider, and negotiate offers.

Life Settlement Producers or Agents

A life settlement producer or agent is someone who attempts to convince people to sell their policies to a particular provider. A life settlement producer may sound like a broker, but he or she owes fiduciary duties *to a provider, not to you*. In other words, a broker is your agent, and a producer is someone else’s. A producer will not seek offers for your policy from multiple providers. Do not confuse a producer with a broker: The difference could cost you tens of thousands of dollars.
The Process of a Life Settlement

The Application

All life settlements begin with the policy owner and the insured completing a life settlement application. If you are using a broker (as we highly recommend), the application will authorize your broker to seek offers for a life settlement. A legitimate broker’s application will not bind you to accept any offer or to pay the broker any compensation directly.

Life settlement applications are long (often taking up to an hour to fully complete), but not complex. The policy owner is responsible for most of items on the application. These items include basic information such as your name, address, social security number, etc. An application will also contain inquiries about past divorces, bankruptcies, premium financing (i.e., loans to pay for the policy), and other financial matters. You must answer these questions fully and accurately because your broker will use them to spot any potential legal encumbrances on the policy. If a provider later discovers a potential encumbrance that your broker did not disclose, your life settlement could be delayed or even voided.

An application will include representations that you must agree to about your ownership of the policy. Read these carefully and make sure they are true before signing. You should also read the disclosures that the broker makes to you very carefully. In particular, note whether your state provides for a rescission period during which you can back out of an offer you have accepted. You will also need to
execute an insurance release form. This form gives your broker the power to get information from the insurance company about your policy.

A life settlement application cannot be completed without the consent of the insured (or his or her personal representative). The insured must complete a list of physicians and medical service providers (such as clinics and hospitals) that he or she has used. Most importantly of all, the insured must sign a HIPAA release that authorizes the broker, underwriters, and providers to collect and review the insured’s medical records.

**Gathering Information**

Once your broker has your completed application, the real work can begin. Usually, a team of people is involved, including the broker who took your application (who often is a “retail” broker that concentrates on finding customers), a “wholesale” broker who specializes in working directly with providers, a compliance officer or attorney, and information retrieval and processing staff. For convenience, we will refer to the entire team as your “broker,” as these people are typically all employees or contractors of one brokerage firm.

Your broker will begin by requesting status information and an in-force illustration from your insurance company. This can often take weeks due to delays by the insurance company. Your broker will also need to make a tactical decision about what kind of underwriting is appropriate for your case. For small policies (under
$500,000), a broker will typically ask the insured to complete a medical questionnaire that can be used by providers to generate life expectancies through automated systems. For larger policies, a broker will usually choose to get life expectancy reports on his or her own to submit to providers. The broker will have to gather medical records to do this, which can often take six to eight weeks. Then the broker will hire two or more underwriting firms to evaluate the medical records and issue life expectancy reports. This can take up to four more weeks. In the meantime, the broker will try to chase down any other information that might be relevant to the sale of the policy, such as trust agreements, bankruptcy discharges, and other documents.

Submission to Providers

Once your broker has all the information he or she needs, it will be time to submit your policy to providers for consideration. Each life settlement provider has its own submission parameters and requirements (both of which change frequently), so your broker will need to contact and prepare submission packages for a number of different providers—sometimes more than forty. Generally, submissions are made simultaneously, but your broker may send some packages earlier or later than others if some providers require more or less time to make offers. This tactic is designed to make sure that as many offers as possible appear within a short period so that no offers expire before all offers are in.
Once the initial offers arrive, which typically takes one to two weeks from submission, your broker will make providers compete against each other to drive up the bids as high as possible. Organizing bidding is more of an art than a science, but a structured process usually yields better results than negotiations without rules.

**Acceptance**

After your broker gets the highest offer possible, you will have a limited amount of time (rarely more than two weeks) to accept the offer. It is important to understand that “accepting” an offer at this stage doesn’t commit you to actually selling your policy. Rather, it is simply a way of telling the winning provider that you are seriously interested in its offer and would like to receive a closing package. Often, the policy owner doesn’t even need to sign anything to “accept” an offer.

**Closing**

If you do accept an offer, your broker will be sent a closing package that contains the actual agreement to sell the policy and other supporting documents. After reviewing the contents for problems, the broker will then present the package to you for review, completion, and execution. You will usually have only a few weeks to complete and return the package. During this time, your broker will be gathering any documents needed to close, which, depending on the provider, may include a physician’s opinion that you and the insured are legally competent, a fairness opinion from an attorney, and updated information about your policy. If you are selling a term
policy, at this point you will also have to complete an application to get the policy converted into a permanent life insurance policy. This will require a conversion premium payment, so make sure to ask in advance if the provider will be reimbursing you for the expense.

After you return the completed closing package to the provider, it will sign the closing agreement. At this point, it is legally committed to proceed with the transaction. The provider will place the purchase money and the broker’s commission into escrow. Once the money is received, the escrow agent will send transfer forms to the insurance company ordering the policy to be assigned to the provider. After the insurance company sends confirmation that this is complete (which, like everything in a life settlement, can take several weeks), the escrow agent will release your money.

**After Closing**

Once you receive your money, you will have a brief period specified by the life settlement contract in which you can rescind the transaction. In other words, you can give the money back to the provider and get your policy back. Some contracts provide that you must pay an administrative fee to the provider if you rescind. If you see such a provision in your contract, you should inquire about it before closing. However, anecdotal evidence suggests that providers often choose not to enforce these provisions even when present in the contract.

After closing, you may receive tax reporting information (like a 1099 form) from the provider. Whether or not you do, you must
report the life settlement on your taxes and pay any taxes due. This might require a payment of estimated taxes before your filing deadline, so be sure to consult a tax professional.
Chapter 8

How to Select and Work with a Broker

The authors believe that consumers are always best-off retaining a life settlement broker to seek offers for their policy. Furthermore, we believe that consumers should be actively involved in the choice of a life settlement broker. If you follow the steps in this chapter, you can find an excellent broker with only modest effort.

A Word of Caution

Hiring a lawyer, a doctor, or even an auto mechanic is often done based on the recommendations of other people, rather than on an independent evaluation of the professional’s merits. Unfortunately, selecting a life settlement broker based on the recommendations of others is a risky proposition unless you confirm yourself that the broker is competent. Many people begin the life settlement process by asking another professional for help. Too often, this is a mistake. As we mentioned in the last chapter, a shocking number of life insurance agents either have no accurate knowledge of life settlements or are actually forbidden by insurance companies to discuss them
with clients. Financial planners and attorneys do not suffer from the latter disability, but many of them have no practical experience with life settlements.

If you have a trusted advisor whom you plan to ask for a life settlement broker recommendation, be sure you know what criteria he or she uses to select brokers. If those criteria do not include the recommendations of this chapter, we strongly recommend that you find another broker on your own. Because life settlements are a relatively new development, even well-meaning professionals with considerable expertise in other areas are often confused about how to find a good life settlement broker.

**How to Select a Broker**

**The Qualities of a Good Broker**

The authors believe that a good broker can be selected by looking for **objective** and **verifiable** qualities. This is different from praise-worthy qualities in some other professions (e.g., real estate agents, lawyers, etc.) in which **subjective** and **intangible** qualities such as judgment, skill, and charisma are of predominant importance. Life settlements are more science than art, and a broker that follows certain practices will consistently produce better results. You truly can determine whether a broker is good simply by asking the right questions.
“Must Have” Qualities

Let’s start with the qualities that your broker must have. First, your broker must be able to conduct business in your state. Because many states still do not have a licensing system for life settlements, this does not always mean that your broker must be licensed. Your broker should, however, be able to explain plainly why his or her firm is able to do business in the state in which you reside, including any licensing requirements applicable to your state. Second, you should verify that your broker will not charge you anything to seek offers and that you will not be obligated to accept any offer the broker obtains—even a good offer. A good broker will bear all the costs of seeking a life settlement for you, including any medical record retrieval and obtaining life expectancy certificates. A good broker will also conduct all transactions through a reputable escrow agent.

Most brokers will meet the above two requirements. Once you have determined your broker does, you can move on to qualities that are rarer: independence and transparency. You can easily determine whether a broker is independent by asking your prospective broker what providers his or her firm works with. If the answer is anything other than “all reputable providers legally able to operate in your state,” you should walk away. Only an independent broker that works with as many providers as possible will get you the best offer for your policy. The authors have repeatedly encountered consumers who retained smooth-talking brokers and got inferior service and offers. Nine times out of ten, we have found that this low-quality broker worked with only a handful of providers to obtain offers. On
some occasions, we have even discovered that the “broker” worked with only a single provider—meaning that even if an offer was made, there was no competitive bidding process. Unless you live in one of only a few states in which licensing burdens have reduced competition (Florida being the most prominent example), you should be able to find a broker that works with 20 or more providers.

If you live in a state that licenses life settlement brokers (which your prospective broker should have explained to you if you asked the basic questions we discussed earlier), ask your broker for a list of all providers in your state with which he or she works. Then ask for a list of all licensed providers and an explanation for any licensed providers with which a broker does not work. An independent broker will be able to meet these demands without much fuss; a captive or lazy broker will probably attempt to dodge your questions. If you have any doubt about whether your broker has provided a complete list, contact your state insurance department, ask for a list of licensed providers, and compare it with the broker’s list. If your state does not license providers, you will not be able to compare your broker’s provider list to a list of all licensed providers. But if that is the case, the number of providers available for your broker to work with will be even larger than in a regulated state. A broker in an unregulated state should be able to provide you an impressive list of providers—perhaps 40 or more.

Your next step should be to verify that your broker is transparent. This quality is extremely important because it ensures that your broker will seek and present offers that pay the most to you, rather
than to the broker. Ask if your broker will relay every offer to you and if each offer will include disclosure of the commission to the broker. You should ask for a sample status sheet showing submission status with providers and offers. A truly transparent broker will let you see exactly what he or she is doing through the submission and bidding process. Avoid at all costs a broker that claims that you cannot be informed of submissions or commissions. On the next page, the authors have included a sample copy of their own firm’s status sheet for reference. (Please note that this reference includes only page one of a several page status report).
Desirable Qualities

Although all brokers worthy of your business will have the qualities mentioned above, some brokers have exceptional qualities that you should seek out. Once again, these are qualities that you can verify yourself.

Just as exceptional doctors and lawyers concentrate in one area of practice, exceptional brokers concentrate in life settlements. Specialization in life settlements is worth far more than general insurance experience—many of the country’s finest insurance agents have no substantive knowledge of life settlements. Ask your prospective broker what percentage of time his or her firm spends on life settlements. The best brokers will say “100 percent.”

While personal attention and service has a subjective component, you can still verify whether a prospective broker has the structures in place needed to yield excellent service. Ask your broker whether you will be assigned a personal case manager or broker. If the answer is yes, ask if you can also have a direct number for a principal of the firm. Life settlements are high value transactions—you should be treated respectfully as a valued client and be able to speak with someone of importance at your convenience. In addition, ask whether your broker has in-house compliance staff, including an in-house attorney to review closing documents. Given the complexities of life settlements, high-end brokers cannot function efficiently without such personnel.
You should also ask whether your broker uses professionals to retrieve medical records for underwriting. The authors once worked on a life settlement that involved the retrieval of more than 1000 pages of medical records at great expense. We later discovered that the rather amateurish broker who had been working on the case previously had submitted only 24 pages of records to the underwriter. As you might expect, the underwriter’s opinion was substantially affected by having an additional 975+ pages of information.

Finally, ask about “funders” and bidding. Some brokers have access to funders, which are the investors that are the money behind providers. Although funders cannot circumvent providers in regulated states, these relationships can still help procure better offers. An excellent broker will also have a structured and disciplined bidding process. Although the same strategy will not work in every case, your broker should be able to explain some of the strategies his or her firm will use to procure the highest offer.

**Qualities Worth Less Than You Might Expect**

The “must have” and desirable qualities that we have discussed lead directly to good offers and a favorable life settlement. There are, of course, many other qualities that you could use to look for a broker; however, these qualities either do not lead directly to good offers, are not verifiable, or are inferior proxies for the qualities of excellence. You should be especially wary of the last category. It is often hard to measure professional expertise, and easy to rely on signs of expertise rather than directly verifying the professional
**Open Life Settlements, LLC**

**Provider Status Report for** 5/13/09

**Number of Licensed Providers in State of:** 36  
**Number of Licensed Providers Contacted and Evaluated:** 36  
**Number of Submissions to Providers:** 19

<table>
<thead>
<tr>
<th>Provider</th>
<th>Policy Submitted?</th>
<th>Status</th>
<th>Net Offer to Owner</th>
<th>Commission to OLS</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Yes</td>
<td>Offer received, unable to match high offer</td>
<td>112000</td>
<td>4.8%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Provider purchases only variable universal products</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Funder cannot match high bid</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Provider out of business</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Policy under evaluation; provider missed final bidding deadline</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Yes</td>
<td>Offer received</td>
<td>66500</td>
<td>2.85%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Offer received</td>
<td>200000</td>
<td>6.0%</td>
</tr>
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qualities and practices you require. Be careful not to make this mistake when choosing a broker.

The size and experience of a life settlement brokerage, for example, certainly tends to show that it is of minimal acceptable quality. These attributes are no substitute, however, for the qualities of excellence that lead directly to favorable offers, such as independence and transparency. Likewise, although an endorsement by a group or celebrity may show that a broker is less likely to be incompetent or dishonest, there is no guarantee that the endorser understands any of the qualities that are important in a life settlement broker. The authors have even seen advocates for senior citizens endorse providers without understanding the difference between a provider and a broker. Rather than helping, this endorsement virtually guaranteed that unsuspecting seniors would receive artificially low offers because of a lack of competitive bidding!

The issue of the geographic location of your broker deserves special mention. Many people want to deal with a “local” broker because they think they will get more effective or honest service. Knowing this tendency, life settlement brokers play up their local connections and representatives whenever possible. The truth, however, is that the location of your broker will not affect the quality of the offers you receive. Most life settlement providers have only a single office, and conduct all their business electronically. As we mentioned in the last chapter, the individual life settlement brokers who take applications and communicate with clients are often representatives for a brokerage firm that does the “wholesale” side of the
life settlement transaction. The brokers in the home office (which can be anywhere in the country) work behind the scenes to process the application, submit the policy to providers, and negotiate offers. These people and their business practices are the real keys to a successful settlement.

If you were hiring a brain surgeon, you would be far more concerned about his or her qualities than those of the nurse who prepares you for surgery. Likewise, you should be far more concerned about the qualities of the brokerage firm that will actually broker your life settlement, rather than the person taking the application. A friendly, knowledgeable local broker will not get you good results if he or she relies on shoddy brokers to actually get offers. Good “retail” brokers, of course, work with good “wholesale” brokerage firms. A good local broker will be happy to explain whether he or she works with a brokerage firm to obtain offers, and should be willing to introduce you (probably via telephone) to the brokers behind the scenes.

Where to find a broker with Good Qualities

Unlike real estate agents and lawyers, life settlement brokers are unlikely to pop out of the yellow pages at you. Compounding the problem is that even if you find a local broker you like, there are likely to be “behind the scenes” brokers at a distant brokerage firm who actually negotiate your offer. How can you find a person—or more likely, a company—with all the necessary and desirable qualities?
At present, we believe the Internet is the best possible way to locate excellent brokers and brokerage firms. (If you are not a regular browser of the Web, we still suggest using the Internet. A librarian or Internet-savvy friend can help you with the steps below.) Start by using Google (or another major search engine) and search for “life settlement broker.” You will get a vast number of results, as well as a number of ads and sponsored links. Copy the Web addresses of all the sponsored links into a word document. Click on “more sponsored links” or go to the next page of results to see additional sponsors, and then copy these Web addresses also. After a couple pages, you should have 20 to 30 potential brokers to research.

Obviously, not every broker advertising on the Internet is a good broker, so the next step is to filter out the weak candidates. First, verify that the site is actually for a professional life settlement broker or brokerage firm. You can start by crossing off all the sites that look crude, contain irrelevant information and links, or that seem to contain little substance other than a form for you to submit contact information. Sites with those characteristics are designed to get you to enter contact information that can then be sold as a lead to life settlement brokers. The sites of real brokers will look professional and be packed with information.

Second, look at the “about us” page (or a similarly titled page), and verify that you are actually on the site of a broker, rather than a provider or advertising firm. All brokers will state plainly that they are a broker or brokerage firm. Cross off any site that does not say this.
Third, look for evidence that the broker is independent and transparent. An independent broker will advertise its status, and will not have any affiliations with a financial institution. A transparent broker will include a detailed description of the life settlement process, as well as explanations of situations in which a life settlement will make sense. If a site is a “black box” with lots of promises about big money but no information about how life settlements work or why you might want to enter one, stay clear. Next, if a site is sufficiently comprehensive, look for other qualities of excellence, such as specialization and personal service.

Finally, look carefully to see if the site is aimed at consumers or financial professionals. The site of a “wholesale” brokerage firm will often include a prominent disclaimer that it is not intended to be viewed by consumers. These firms will probably be willing to refer you to a local “retail” broker if you call, but may not be interested in answering your questions directly.

Once you have found a few brokers that show qualities of excellence, it’s time to make contact. Gather basic information about your policy, such as its type (term, universal, whole, etc.), face value, and premiums. Make sure that you know who the insured is, and their age and health. Then call the prospective broker and ask systematically about the qualities of an excellent broker described in this chapter. You should be able to have this conversation with an actual broker or a principal of the brokerage firm, rather than a customer service representative. Ideally, whatever person you talk to should be your actual point of contact if you decide to go ahead with an application.
If your contact provides you good answers about the policies and processes of the broker, describe your personal situation and the basic parameters of your policy. A good broker will be able to analyze your situation and present your options in plain English.

Beware of anyone who promises a specific dollar amount—this is impossible to truthfully promise before you actually go through the process of seeking offers. Sophisticated brokers may, however, be able to estimate the maximum theoretical value of your policy or even roughly estimate a range of likely offers if you provide accurate policy information. Be advised that estimates for term policies are extremely difficult to make unless you know what your policy will look like after it is converted into a permanent policy. Also, keep in mind that initial estimates for universal policies tend to be too high. This is because most people underestimate the premiums needed to keep a policy in force until the insured’s death—these premiums are often much higher than what you have been paying. Be especially careful not to select a broker based on who promises you the most money or gives you the highest estimate--unethical brokers tend to inflate their estimates.

Do not be afraid to contact several brokers before you agree to fill out an application. You should be completely comfortable with the broker and the life settlement process before you proceed. Do not fill out any applications until you’ve settled on a broker.
How to Work with a Broker

Working with a good, professional life settlement broker is not difficult. With a few basic principles in mind and a little background information, you can keep the process smooth and save yourself (and your broker!) a lot of aggravation.

Some Basic Principles

First, remember basic courtesy. You should expect and demand to be treated well by your broker, and you should do the same for him or her. Second, do not waste a broker’s time by applying for a life settlement unless you are actually interested in one. (Review Chapters Four and Five if you need guidance on whether a life settlement makes sense for you.) Too many consumers use the life settlement process as a way to get a free “appraisal” of their policy. This is obviously bad for brokers, but it is also a bad idea for you. Most life settlement providers will not bid on a policy that they have seen too recently, and may lower their bids or even decline to make offers on a policy that has been repeatedly offered for sale. Seeking offers when you are not seriously interested may leave you unable to get a fair offer when you want or need one in the future.

Third, try to have realistic expectations. If you desire a certain amount of money for your policy, discuss it with your broker up front. The authors have dealt with consumers who got outstanding offers for their policies, and rejected them out of hand because of wildly unrealistic expectations. Life settlement offers are constrained by fundamental economic principles, particularly the time
value of money. If keeping your policy is an option, ask your broker for a rough range of possible offers before you get too far into the process. Often, a broker will let you complete a HIPAA release and insurance information release before you complete a whole application. This will let the broker estimate the insured’s life expectancy (usually through a medical questionnaire) and obtain a proper in-force illustration for your policy. With that information in hand, your broker should be able to roughly estimate a range of likely offers.

Fourth, be completely honest and forthright throughout the life settlement process. When it comes to sensitive issues like health, finances, and legal matters, it is very tempting to bend the truth a little or to leave out potentially embarrassing events or details. Misleading or hiding things from your broker, however, is as counterproductive as doing so with your doctor or lawyer. Your broker will not ask you a question unless the answer is potentially important. Any misinformation you give your broker could be passed on to providers. If providers discover they have been misled on any point—even a minor one—they will back out of the transaction and refuse to deal with you in the future.
**Good Practices at Each Stage**

Keeping those basic principles in mind, let’s walk through good practices at each stage of the settlement process. Before you set up an appointment to fill out an application (whether in person or by phone), make sure you have all the necessary information in hand. This should include:

- your insurer’s name and your policy number
- the face value of your policy and your current premium payments
- the date your policy was issued
- if the policy is in a trust, the trust agreement
- the name and number of the insurance agent who sold you the policy
- a list of the insured’s doctors and medical service providers (such as hospitals and clinics), including phone numbers
- if you’ve ever been divorced or bankrupt, the dates of these events
- a copy of your photo ID and the insured’s photo ID

You should also be certain that the insured is willing to participate in the process before you commit to completing an application.

With all the necessary information in hand, completing the application will be relatively easy. Still, it will take about 30 to 45 minutes under normal circumstances. Whether you wish to com-
Complete an application in person or over the phone is a matter of personal preference. Completing it in person may be faster and make it easier to quickly correct mistakes, but an application over the phone is often far more convenient. If you are completing the application with your broker over the phone, he or she will typically type the information into the forms and then mail them to you for signature. Regardless of how the application is completed, be sure to review the documents carefully for errors. Both you and the insured will need to sign at various places. Having a disinterested witness (such as a relative or friend) available for signing is a good idea, but most applications do not require notarization.

**Should I hire more than one broker?**

If one broker is good, two brokers must be better, right? Not so. Hiring two brokers is as crazy as hiring two law firms to file a personal injury lawsuit, or two real estate agencies to sell your house. Two brokers will not get you twice as many offers. To avoid conflicts over commissions, providers will work exclusively with the first broker to submit a particular case to them. Thus, two brokers will still only get you one offer per provider. Moreover, because each broker will be working with only some of the providers, it will be harder for each individual broker to negotiate the highest offer. Hiring two brokers may even result in a dispute over who gets the commission, which could tie up your policy in litigation and leave you without a settlement. It is far better to hire one excellent broker that you know will submit your policy to all interested providers than to hire several brokers.
Once an application is returned to your broker, the next step is to wait. Despite the best efforts of brokers everywhere, a life settlement still takes an incredible amount of time compared to other financial transactions. You should expect it to take four to eight weeks to obtain medical records from the insured’s health care providers and illustrations from the insurance company. You will not have to do anything during this time unless your insurance company refuses to send information directly to your broker, and instead sends it to you. Regrettably, this is a fairly common occurrence. If that happens, you can speed things up by passing on information as quickly as possible to your broker.

After medical record and insurance information retrieval is complete, you should expect around another month to pass before the underwriters finish their life expectancy reports. (If your policy is $500,000 or less, you may be able to skip this step by completing a medical questionnaire.) Depending on the case’s complexity, your broker will need anywhere from a few days to a few weeks to assemble packages of information for providers. The bidding and negotiation process will then take another three to four weeks under normal circumstances. If you accept an offer, closing will take anywhere from four to eight weeks, depending on the provider’s requirements. Even the speediest life settlement will take three months if you want your broker to seek the maximum number of offers. More realistically, a typical fully underwritten life settlement takes between four and six months to complete.

All the waiting can be hard to deal with. Be assured that it’s not any easier for brokers. They must prod and shove third parties
at every point in the transaction to keep things moving, and work for months with no assurance of any compensation. You and your broker should stay in touch during the long preliminaries before bidding starts, but keep in mind that often your broker will have nothing very interesting to report prior to bidding. Almost every status report from a broker early on in the life settlement process will begin with “I’m waiting for ....” Try your best not to get impatient.

Once your broker is ready to submit your policy for offers, you should expect (and insist on) frequent communications. Your broker should provide you a list of all providers to which his or her firm has submitted your policy. If you are living in a state that regulates life settlements, your broker should also be able to provide you a list of all providers that are licensed in your state. If your broker has not submitted to certain providers, ask for an explanation. It is normal for a broker not to submit your policy to some providers. Your policy will not meet the purchase parameters for some providers, and others may simply have no funds to buy policies at the moment. However, if your policy is more than $500,000 and you see that your broker has submitted your policy to only a handful of providers, you should demand an explanation. Relatively few providers buy small policies, but a larger policy should be broadly marketed.

For the first few days after submission, no offers may come back. After one to two weeks, however, offers should start coming in. Each provider has its own bidding strategy. Some like to start low and bid up as more offers come in. Others prefer to make a large opening bid designed to shut down further bids. All offers will come with some sort of deadline. Sometimes these deadlines are
very short—even a single day. These deadlines are usually designed to create pressure to accept. Your broker will use his knowledge to identify these phantom deadlines and attempt to get realistic ones. A deadline to accept an offer that is one to two weeks, however, is a serious deadline. Providers strongly resist holding open offers for extended periods. This is not simply a negotiation tactic—providers have a limited pool of money released from funders to buy policies. Each open offer ties up funds that could be used to buy another policy. Extending too many offers risks getting more acceptances than the provider has money to fulfill. Providers therefore impose deadlines to limit their exposure to open offers.

Because of the deadlines, you will have a short period of time to make up your mind. Use all the time up to the deadline of the highest offer to give your broker a chance to negotiate higher offers, but don’t let a real offer slip away because of hypothetical offers that aren’t in writing. Also, be certain that you are comparing apples to apples when looking at offers. Make sure all offers are net offers that do not include your broker’s commission. Also make sure that the offers take into account any reimbursement for final premiums you will need to pay. Term polices will almost always require an expensive conversion premium payment to be paid. You should try to get reimbursed for this if possible, and you should definitely take that reimbursement (or lack of it) into account when evaluating offers. Your broker should provide all the information needed to make an apples-to-apples comparison for you without prompting, but stay alert.
What if I am unsure if an offer is enough?

If you are thinking about keeping your policy if an offer isn’t high enough, we suggest asking your broker or a financial adviser to perform a “hold-or-fold” analysis on your life settlement offer to see if keeping your policy or taking the life settlement generates more economic value. A hold-or-fold analysis looks at the time value of the cash flows involved in retaining (holding) or selling (folding) a policy. The results of such analysis often surprise people—often life settlement offers that seem small generate just as much economic value as keeping a policy once the time value of money and the cost of premiums are taken into account.

As a very simple example, suppose that you have a $1,000,000 policy that has no premium payments—it is completely paid-up or the premiums are being paid by a disability waiver that has no chance of expiring. Further suppose that the insured’s life expectancy is 10 years, and that you think a reasonable rate of return on an investment you could make (or the interest rate of a debt you would like to pay) is 9 percent per year. The present value of the $1,000,000 policy at that interest rate is $422,411. This means that a rational person would be indifferent between $422,411 now as a life settlement or keeping the policy and getting $1,000,000 in 10 years. (If you had to pay premiums to keep the policy, the present value would be much lower.) No rational investor will pay more for a policy than the present value of a policy computed at an interest rate it believes is reasonable. Likewise, you would be foolish to pass up a life settlement offer that is greater than your estimate of the present value of the policy.

A sophisticated hold-or-fold analysis will show you all the cash flows discounted for the passage of time, and also adjusted for the impact of taxes. It will also show how long the insured must live for the life settlement offer to prove more valuable than
retaining the policy. The life settlement offer will always be the less valuable option if the insured dies earlier than expected, but should always become more valuable than the policy if the insured lives longer than expected. Obviously, neither you nor the life settlement provider actually knows how long the insured will live, but a good hold-or-fold analysis can help you see whether a life settlement is a prudent economic choice. One note of caution, however: If you are thinking of keeping a policy as an investment, be sure the premiums are comfortably affordable throughout the predicted lifespan of the insured. No investment is a good one if you can't afford it!

If the high offer for your policy seems reasonable to you, instruct your broker to accept it. Although accepting an offer sounds like a serious commitment, in the strange world of life settlements it has less legal importance than one would think. Accepting does not bind you to sell your policy; rather, it cuts off bidding and tells a provider to send you a closing agreement. Until you sign the closing agreement, you are not legally obligated to do anything. So while you should not accept an offer that you have no realistic interest in, you should not let a good offer expire just because you have lingering doubts about proceeding. If you change your mind after accepting, don’t sign the closing agreement.

Closing is often the most difficult part of a life settlement. Your broker will do most of the hard work, but you need to be prepared to act quickly to fulfill his or her requests. Providers set a strict limit for signing the closing agreement and completing the transfer pro-
cess—delay, and your sale will be cancelled. The first thing you should do is to check with your broker to see if any last premium payments must be made by you. This is usually required with term policies in order to convert them to permanent policies. Often, you will be reimbursed for these conversion payments at the end of the settlement, but you will still need to come up with the cash initially. If you do not have the money available, look for an inexpensive way to borrow the money well in advance.

Next, set a date and time to sign the closing documents. If you are going to have an attorney or financial adviser review the closing documents, be sure to allow several days for their review. Closing packages often comprise a dozen or more documents, so be sure that you pick a block of time for closing in which you and all other parties have at least an hour free. Ask your broker in advance who will need to sign at closing. At the minimum, the owner of the policy, the insured, and a notary will need to be present at closing. Most closings also require beneficiaries to sign releases of their rights. You may also need someone to sign as a contact person for the new owner to ask about the health of the insured in the future. This usually needs to be someone living at a different address from the insured.

Many life settlement providers will conduct a pre-closing telephone interview with the policy owner and the insured to ensure that everyone understands the transaction. These interviews are usually short and straightforward. You will be asked a few basic questions about the policy and your reasons for entering the life settlement. This is not a test, so don’t be nervous. Answer truthfully and di-
rectly, and you will not have any problems. Remember, at this point, the provider definitely wants to proceed with the transaction.

Some life settlement providers will also ask you to get a statement from your physician that you are mentally competent. You should be provided a form for this statement. The easiest way to get it signed is just to drop it off at your regular doctor’s office with a note explaining that you need the form completed as soon as possible.

A few providers will also ask for a “fairness” opinion from an attorney which states you understand that the transaction and that it is in your best interest. This opinion can be difficult to obtain if you do not have easy access to an attorney who understands life settlements. The easiest (and often cheapest) way to obtain such an opinion is to ask your broker for help. A good broker should be able to refer you to an attorney who can issue the opinion after a telephone interview. (If you want to drive a hard bargain, you can also ask your broker to pay for the attorney’s opinion. Be advised, however, that the attorney must agree to represent you exclusively in the transaction regardless of who pays the fee. An attorney who works for the provider or broker will not be able to represent you.)

Closing day should not be dramatic if you and your broker have prepared for it thoroughly. Your broker will explain each document to you and other parties before they sign them. The key items are the purchase agreement, HIPAA release, and transfer forms. The purchase agreement is the actual contract between the policy owner and the life settlement provider to buy the policy. Be certain to make sure
that the purchase price (including any premium reimbursements) is right. Also be sure that you understand how you can rescind the contract and how long you have to do it.

The closing package will include a HIPAA release or special power of attorney to allow the provider to access the insured’s health information. This right will often extend indefinitely into the future—this is because the provider may need to review the insured’s health information again if the policy is resold in the future. Several clients of the authors have expressed concern about giving a provider broad future rights to health information. This is completely understandable, but we believe the actual risk of a major, reputable provider abusing an insured’s health information is low. It takes time and costs considerable money to obtain health records. There is no more reason to think that a life settlement provider will snoop into your health information on a lark than an employee at your doctor’s office or insurance company—both of whom have far easier access to your information.

The transfer forms you sign at closing are the documents that actually instruct an insurance company to transfer your policy to the new owner. As strange as it may sound, it is normal in a life settlement to sign blank and even undated copies of these forms at closing. This makes it easier and faster to transfer ownership. You and your broker will protect yourself from the abuse of these forms by proper use of the escrow agent. Keep in mind that it is much easier to get an insurance company to halt a transfer than it is to get one
approved, and that you have a rescission right that you can use to cancel the transaction if anything goes wrong.

Once the closing documents are signed and notarized, take a few minutes to flip through them once more with your broker. Because every provider has different closing forms, even experienced brokers sometimes miss an initial or signature block that you must execute. These mistakes can be remedied after the fact, but it is better to catch them before you send in the documents. Also be sure to keep a copy of the documents for your records.

Once the documents are mailed to the escrow agent, prepare to play the waiting game again. Your broker will be working on obtaining verification of coverage statements, illustrations, and other documents needed to finish the closing. Most of these items require the participation of the insurance company, which is rarely in a hurry to complete the transaction. It usually takes four to six weeks to finish everything. During that time, you should not be surprised if your broker presents questions to you from the provider, requests documents regarding any unusual circumstances surrounding your policy (e.g., bankruptcy, divorce), or even asks you to sign additional forms. Life settlements are big transactions that are risky for the purchaser, so you should expect some additional “due diligence” inquiries from the provider.

Once your policy is transferred to the new owner, the escrow agent will release your money to you by wire transfer or as a certified check. Expect payment within two or three business days of the
transfer. The money is yours free and clear as soon as you receive it. But be sure to pay Caesar—it is an excellent idea to consult a tax professional as soon as possible to make sure you meet your tax obligations.

After you get your money, you may never hear from the life settlement provider again. If you have designated a contact person for the provider to call regarding the insured’s health, they will call that person once or twice a year to make sure the insured is still alive. These calls are almost always outsourced to professional services that specialize in such monitoring. Consequently, the calls are usually highly scripted and discreet.
Conclusion

Congratulations! If you have made it this far in this book, you know a lot about life settlements, including everything you need to know to select an excellent broker and enjoy a smooth transaction. Whether or not you decide to enter a life settlement, we hope that this book helps you make an informed decision. If you have any questions or comments for the authors, don’t hesitate to contact us at (866)-877-4054. We would love to hear from you. We also recommend visiting the Web site for this book at www.lifesettlementshandbook.com for updated information and additional content.
Appendix A:

Tax and Financial Planning Considerations

Tax Treatment of Death Benefits

Tax laws treat life insurance very favorably. The general rule is that death benefits (the proceeds paid when an insured dies) are not subject to federal (or state) income tax. This is an important benefit, but also one that is often overstated. Death benefits are not universally tax-free. Death benefits are subject to estate taxes, gift taxes, and other taxes other than income taxes.

The most important tax on death benefits is the estate tax. The estate of a deceased person consists of all property he or she owns, minus certain deductions. If a person owns a life insurance policy, the proceeds are part of his or her estate even if the deceased’s estate is not the beneficiary of the policy. For example, suppose Fred owns a policy on his own life with a face value of $500,000. His daughter Rachel is the sole beneficiary. Fred passes away, and Rachel receives $500,000. The $500,000 is considered part of Fred’s estate, and may be subject to estate taxes.

Fortunately, estates are exempt from federal estate tax up to a certain dollar limit. For 2009, this exemption is $3.5 million. Estate
values above the exemption may be taxed at rates up to 45 percent. After 2009, it is unclear what will happen to the estate tax. In 2010, the estate tax is scheduled to be repealed entirely, but in 2011 the estate tax is scheduled to return with an exemption of only $1 million and a maximum tax rate of 55 percent. It is possible that Congress will eliminate the estate tax for good, but it is more likely that it will stick around in some form, with the exemptions and rates shifting periodically in accord with the prevailing political winds.

The bottom line is that death benefits are not always tax free, and you should plan accordingly. If you own substantial assets, consult an estate planner before you assume that the death benefits will not incur estate taxes.

**Taxation of Surrender or Lapse**

As we discussed previously, the vast majority of life insurance policies never pay a death benefit. It is much more common for policies to lapse, expire, or be surrendered in exchange for their accumulated cash value. The tax treatment of lapse or expiration is simple. If your policy lapses or expires, you incur neither income nor loss for tax purposes. Don’t be fooled into thinking that you can somehow deduct the premiums you have paid as an investment loss if your policy lapses. If you spent $100,000 on premiums for a universal life policy that lapses with no cash value, your loss is $0, not $100,000.
If you surrender a policy and receive its cash value, you may have to pay income taxes. The cash you receive is tax free up to the amount of the premiums you have paid over the lifetime of the policy (less any untaxed dividends you received). Any amount above the premiums you have paid is treated as ordinary income. This is not particularly favorable tax treatment, since ordinary income tax rates currently range as high as 35 percent for federal taxes alone. Moreover, receiving a big cash surrender payment can quickly cause someone with otherwise modest income to hit a top tax bracket.

**Taxation of a Life Settlement**

Incredibly, practitioners are still debating the proper tax treatment of life settlements. Recent guidance has clarified the IRS view of how life settlements should be taxed, but in some ways this guidance has only added to the debate. The taxation of life settlements seems destined to be resolved by the Tax Court—probably in multiple cases.

Prior to the new IRS guidance, the simple and logical view was that a life settlement should be treated like a surrender for cash value plus the sale of an investment. As with a cash surrender, the cash you receive is tax free up to the amount of the premiums you have paid over the lifetime of the policy (less any untaxed dividends you received). If the cash surrender value is greater than the premiums paid, the amount above the premiums you have paid is treated as ordinary income up to the cash surrender value of the policy. Any amount above the cash surrender value (or the premiums paid, if
greater) is taxed as long-term capital gain, which enjoys very favorable tax rates (presently 15 percent, although an increase to 20 percent seems likely).

Let’s work through some examples of this tax treatment.

Example #1: Mary has paid $50,000 in premiums for her policy since it was issued. The policy now has a cash value of $80,000, and she sells it for $120,000. The first $50,000 of that $120,000 payment is tax free because it is a “return of basis.” The next $30,000 (up to the $80,000 cash value) is taxed as ordinary income. The final $40,000 (the amount above cash surrender value) is taxed as a long-term capital gain.

Example #2: Bob has paid $400,000 in premiums for his policy. Unfortunately, his policy has performed poorly, and has only $100,000 in cash value. Bob manages to settle the policy for $250,000. Bob pays no taxes because the entire amount he receives is less than the premiums he paid. Bob cannot deduct any amount as a loss, however, even though he paid $150,000 more in premiums than he sold the policy for.

This view of the taxation of life settlements has been under unofficial challenge by the IRS for a number of years. In a private letter ruling dating back to 1994 and in a 2005 legal memorandum (ILM 200504001), the IRS has opined that money received for a life insurance policy is tax free up to the premiums paid, less any untaxed dividends and the “cost of insurance protection provided through the date of sale (such as, loading charges, expense charges,
mortality charges and administrative fees).” In other words, the tax free amount (the “basis” of the transaction) must be adjusted downward to account for the cost of all the insurance protection one received, even though it never resulted in the payment of a death benefit.

After some prodding by Congress, the IRS made this position official (albeit only for transactions after August 25, 2009) in Revenue Ruling 2009-13. This position is considerably less popular among the life settlement industry and many tax professionals since it invariably results in greater tax liability for the policy owner. For example, in a sale of a term policy through a conversion, the policy essentially has no basis because all the premiums paid for the term policy were costs of insurance that must be subtracted from basis.

The IRS position has a number of severe flaws. There is no obvious reason why a cash surrender and a life settlement should be accorded such disparate treatment. Also, Revenue Ruling 2009-13 runs contrary to a number of prior court decisions and fundamental tax principles. On the other hand, although a revenue ruling does not have the force of a regulation, the position of the IRS is precedent and cannot be ignored. Only litigation or Congressional intervention will settle the matter. We suggest consulting an experienced accountant or tax attorney on this issue, but, when in doubt, calculating taxes according to the IRS position is obviously safer.

Life settlements can also be subject to state and local income taxes. Due to an almost total lack of guidance from state and local
tax authorities, we suggest calculating the state and local income produced by a life settlement in the same manner as federal income unless you have direct authority for a different treatment.

**Policy Loans and Withdrawals**

As we discussed in Chapter Five, there are a number of other ways to extract value from a life insurance policy other than surrender or a life settlement. Policy loans and withdrawals are two ways to tap the cash in a permanent life policy while keeping it in force. A policy loan usually is not taxable income. If, however, on the surrender or termination of your policy, the outstanding loan and interest (plus any dividends paid) exceeds the premiums you paid, you will have a net taxable gain. This can be an awkward situation, since you will have a tax bill, but no money coming from the policy to pay it. Too often, this situation occurs when a policy owner takes out loans and does not pay the interest. When the loans and interest exceed the cash value of the policy, the policy will terminate. At that point, the policy owner will receive a Form 1099 from the insurer if there is a taxable gain.

A withdrawal is generally not taxable up to the premiums paid. If a withdrawal reduces benefits under the life insurance policy and this change occurs during the 15-year period beginning on the policy’s issue date, the withdrawal may be taxable.
Viatical Settlements and Accelerated Death Benefits

As you read earlier, life settlements arose as an extension of viatical settlements, which are sales of life policies where the insured is terminally ill. These transactions originally were taxable just like a life settlement. Congressional concern over the taxation of the ill and dying later led to exemption of viatical settlements and accelerated death benefits from federal taxation. A federal law known as "HIPAA" provides that a viatical settlement or qualified accelerated death benefit is not taxable if the insured is terminally ill. HIPAA defines "terminally ill" as being certified by a physician as having a condition that can reasonably be expected to result in death within two years.

HIPAA also provides that viatical settlement proceeds or accelerated death benefits paid to the "chronically ill" are not taxable. HIPAA defines a chronically ill person as one who is unable to perform at least two activities of daily living—such as eating, bathing, and dressing—for at least 90 days (or similar disability), or who requires "substantial supervision to protect such individual from threats to health and safety due to severe cognitive impairment." Accelerated death benefits for the chronically ill are subject to special limitations. Such benefits can only be paid as compensation for long-term care services that are not reimbursable by Medicare (except as a secondary payor) and, if paid on a per diem basis, are subject to a daily dollar limit on long-term care insurance.
Appendix B:

Legal Considerations for Fiduciaries such as Trustees, Lawyers, and Financial Planners

The emergence of a secondary market for life insurance creates a number of new considerations for fiduciaries. The liquidity and potential increase in value offered by a life settlement may advance client objectives in a wide range of scenarios. A prudent fiduciary cannot ignore the existence of a secondary market for an asset.

Trustees

Trustees, in particular, should educate themselves on the uses, advantages, and drawbacks of life settlements. In the opinion of a number of commentators, trustees of trusts that hold life insurance policies almost certainly have a fiduciary duty to at least consider life settlements. It is an ill-kept secret in the world of trusts that most trustees do not actively monitor life insurance assets. One survey conducted in 2002 found that 83.5 percent of professional trustees have no formal procedures for reviewing life insurance. A 1998 study by Towers Perrin found that 75 percent of life policies held by bank trustees more than five years could have been exchanged for a 40 percent increased death benefit at no additional cost. Such neglect has always been poor practice, but in the age of life settlements, it is practically an invitation to a suit for breach of fiduciary
duty. The consideration of a life settlement should be part of every trustee’s routine review of life policy assets.

Keep in mind that, in the opinion of a number of attorneys, the Uniform Prudent Investor Act applies to life insurance, meaning that life insurance must be monitored, managed, and, if necessary, sold like any other trust asset. This means that trustees may be liable for failing to exploit the secondary market for life insurance when prudent. Life insurance is uniquely suited for certain goals, such as paying estate taxes, but trustees must consider whether retaining a life insurance policy makes sense for the trust.

If you are a trustee, integrating life settlements into your toolkit does not need to be difficult. As with other assets, the law does not make you responsible for the outcome of an investment in a life insurance policy. Your duty is to engage in a prudent (and well-documented) process to monitor and manage the policy. Life settlements should be part of this process. In particular, we believe that you should expressly consider a life settlement in the following scenarios:
Scenario #1: You are about to surrender a policy or let it lapse.

If you are about to surrender a policy or let one lapse, you must consider whether a life settlement is possible. If a settlement can be obtained, it is virtually impossible for it not to result in a net increase of trust assets under these circumstances—a life settlement offer will always be for a greater sum than a cash surrender value. In many cases, no settlement will be possible because of the life expectancy of the insured or the nature of the policy. If that is so, simply fill out a qualifying worksheet from a life settlement broker, and file it to document your prudent consideration of the possibility.

If a settlement is potentially possible, contact the insured to see if he or she is willing to release medical records and perform the other steps necessary to explore a settlement. If the insured is agreeable, contact a life settlement broker. Make sure that the broker is licensed, and ask in advance about commissions. A competent broker will do virtually all of the work necessary to seek offers, and, if you decide to accept an offer, will work with the life settlement provider to ensure a smooth closing. Once the cash is in the trust, you can then follow your normal procedures to invest it prudently.
Scenario #2: You are considering a 1035 exchange

If you are considering a 1035 exchange, you should consider whether a life settlement—either by itself or in conjunction with a 1035 exchange—would better serve the trust’s objectives.

Scenario #3: You Foresee Problems With a Policy

If a policy’s performance trend is poor, or if you believe that a life policy will not serve trust objectives in the future, you should consider whether a life settlement could fund a better investment. This is especially true where life insurance is being used primarily as a funding vehicle, rather than to guard against some contingency. It is not at all uncommon for trust objectives to be better served by selling a shaky policy for cash that can be used to purchase solid, conservative investments. In other cases, a life policy may be an adequate performer, but no longer needed by the trust. A policy to fund estate taxes, for example, may become of little use if the estate plunges in value. In that case, it may be better to sell the policy and invest in assets expected to yield a superior return, rather than to keep paying for insurance that is no longer needed to guard against sudden estate tax expenses.
Attorneys

Attorneys risk malpractice if they do not consider life settlements when giving advice to clients. Even a term policy can frequently be settled for value. Business attorneys will find that obsolete or unneeded policies funding buy-sell agreements, key man insurance, and split-dollar arrangements are frequent candidates for settlements. The life insurance policy of a client experiencing divorce is a potentially valuable asset that must be evaluated when equitably dividing property. Bankruptcy trustees will also find that a life settlement can produce unexpected value for a debtor’s estate. A call to a life settlement broker can insulate an attorney from malpractice claims for wasting an asset, while potentially creating real value for the client. (What would make a client happier than finding money he didn’t know he had?)

Most state life settlement statutes permit attorneys to broker life settlement transactions (although attorneys are not permitted to receive commissions). In the opinion of the authors, however, this is almost never a good idea. Few attorneys have the contacts or experience to obtain maximum value in a life settlement transaction. Trying to broker a transaction without the requisite experience merely puts the attorney at risk for malpractice again. Also, given that most policies submitted for review do not settle, clients are generally better served by a broker who operates on a contingent commission, rather than an attorney’s hourly fee. (Few clients will relish paying an invoice for 50 billable hours of time that resulted in no offer.) Finally, some commentators believe that an attorney who becomes involved
in a settlement risks selling a security (to the provider) under blue sky laws—that possibility alone should give an attorney an excuse to “let someone else do it.”

Financial Planners

As with trustees and attorneys, the authors and many other commentators believe that financial planners have a fiduciary duty to consider life settlements under at least some scenarios. In our experience, a surprising number of clients are willing to pay for life policies that have no apparent role in their financial plans. Especially when a client’s life circumstances change, you should consider whether it is appropriate to discuss a life settlement. Never let a policy lapse or accept surrender value without considering a life settlement. Despite the early state of the life settlement market, the authors have already heard anecdotal evidence of lawsuits being filed against financial planners who allowed policies to lapse without considering life settlement.

As with attorneys, financial planners cannot accept a commission in most states for brokering a life settlement. For many of the same reasons that apply to attorneys, we believe it is inadvisable for a financial planner to seek to broker a transaction.
Appendix C:

Considerations for Businesses

Life settlements aren’t just for individuals: Businesses can also use life settlements to transform an unneeded policy into a liquid asset.

Businesses frequently purchase life insurance policies for a variety of reasons. The most common are:

- to fund a buy-sell agreement upon the death of a shareholder;
- to fund executive compensation; and
- to guard against the death of a key employee.

Sometimes, businesses also purchase life insurance as a general investment, although new tax rules enacted as part of the Pension Protection Act of 2006 may make this less common.

Corporate-owned policies can provide essential financial security in many situations, but changes in circumstances frequently render these life insurance policies obsolete. For example:

- A key employee policy may become unneeded after the retirement of an executive.
• Compensation changes or the departure of an executive may make a policy to fund deferred compensation unnecessary.

• Transfer of ownership may be completed without the use of a life policy funding a buy-sell agreement in the event of a shareholder’s death.

Life settlements provide businesses a profitable alternative to policy surrender. With the help of a life settlement broker, exploring this option is easy and involves no upfront costs or commitments.

Life settlements are often particularly valuable in solving executive compensation issues. They also have valuable uses related to split-dollar life executive compensation. After the departure or retirement of an executive, split-dollar arrangements often result in the retention of the policy by an executive. Frequently, the executive would prefer to have immediate cash, rather than a future death benefit. A life settlement can be used in these circumstances to transform the policy into a liquid asset—often far more effectively than through loans, withdrawals, or surrender. Life settlements are also an important tool to “unwind” split-dollar arrangements (or other life insurance funded compensation arrangements) that have gone wrong. An arrangement may perform poorly due to unexpectedly low policy returns or a participant who lives longer than anticipated. When faced with the unexpected premium payments or withering cash value, a life settlement can be a profitable way out.
Appendix D:

Considerations for Insurance Agents and Brokers

If you’ve never considered a life settlement, you’ve been leaving money on the table for your client—and possibly for yourself.

If you’ve had any success, you probably have replaced a client’s life insurance policy with a better policy from your own company. Typically, the policy being replaced is either cashed in or allowed to lapse. In these situations, a savvy professional will first consider a life settlement.

A successful life settlement will net your client (on average, based on recent industry-wide figures) about four times what he or she would have received in cash value for the policy. (Or, in the case of a term policy, something instead of nothing!) And, if you are a licensed life settlement broker or in a state where no licensing is required, you will receive a commission much larger than any you may have realized from selling a life insurance product. Even if you are not a licensed life settlement broker, a life settlement can result in greater commissions to you by enabling your client to buy a larger replacement policy. A life settlement is often the most beneficial way to dispose of a life policy for both you and your client.
Appendix E:

Considerations for Charities

Donating a life insurance policy to charity has long been a way for people to provide support to their favorite organizations. Even those with small cash reserves can make gifts of significant value through the donation of a life policy. The life settlement industry has greatly increased the flexibility of these donations in ways that can benefit both the donor and the organization.

There are two traditional methods of benefiting a charity through life insurance: a donor can name the charity as the policy’s beneficiary, or the donor can assign the ownership of the policy to the charity. Naming the charity as beneficiary will only provide current tax benefits to the policy owner if it is an irrevocable designation. Retention of just about any control over policy—including power to change the beneficiary or to borrow against the policy—precludes a deduction by the donor. Also, the charity obtains no immediate benefit by being designated as a beneficiary, and will only receive money from the policy following the death of the insured.

Assigning the policy to the charity is generally more tax-advantageous to the donor. The amount of the deduction depends on the type of policy that is contributed. Generally, the donor can deduct an amount roughly equal to the surrender value of the policy as well
as any ongoing premium payments made by the donor. The donor is not obligated to continue to pay premiums, however.

If the donor does not wish to continue making premium payments, the charity has three options. The first option is for the charity to take on the responsibility of paying the policy premiums and eventually receive the full face value of the policy upon the death of the insured. While it is common for larger charities to do this, it is often not financially feasible for smaller organizations. Also, the charity receives no immediate benefit from the gift, receiving funds only upon the death of the insured. A second option is for the charity to convert (if possible) the policy into a paid-up policy of reduced face amount on which no further premiums are payable. As with the first alternative, this provides no immediate benefit to the charity because it will not receive any benefit until the death of the insured. A final alternative is for the charity to surrender the policy for its cash value. While this does provide an immediate financial benefit to the company, it fails to maximize the full potential of the life policy gift.

Life settlements create a new option for charitable donations of life policies. Life settlements have significant benefits that the other methods of donating life policies fail to offer. By settling a donated life policy for cash, the charity will usually receive substantially more than the cash value of the policy. This benefits not only the charity, but the donor as well. Because the gift of a policy will have a much higher value if it is sold through a life settlement, the donor
may be able to claim a much larger tax deduction from the donation.

There are a number of other ways in which life settlements are advantageous for charities. By settling the policy, the charity will be free of the responsibility of paying future premiums. This can be especially important for smaller charities, which could risk having the policy lapse if a tight budget year led to difficulties keeping up with payments.

Most importantly, the charity receives significant income that can be put to use right away for immediate needs. This is also a final advantage for donors: life settlements provide a way for donors to witness the fruits of their life policy gifts while they are still alive.
Appendix F:

Sample Letter Requesting Policy Information

____________________
Date
____________________
Insurance Co.
________________________
Policy Owner
________________________
Policy Number

To Whom It May Concern:

I am writing this letter to request the following documents related to my insurance policy:

1. A status sheet, including current face value, cash value, and loan balance.
2. An in-force illustration run with minimum level premiums that take policy to age 100 with a level death benefit and minimal cash value at age 100.
3. If this policy is a convertible term policy, please provide a conversion illustration (including yearly outlays, account values, and death benefits) to a flexible universal life insurance product, showing minimum level premiums that take the policy to age 100 with level death benefit and minimal cash value at age 100.

4. If the policy is a convertible term policy and no UL product is available, please include an illustration (including yearly outlays, account values, and death benefits) for your least expensive whole life product showing level premiums and death benefit to age 100.

5. A copy of my policy, including all riders and amendments. Please mail these documents to me as soon as possible at:

[Name]

[Complete Mailing Address]

If you have any questions, please call me at [phone number]. I thank you in advance for your prompt attention to this matter.

Sincerely,