BY TERRY M. MAGADY

Selling Life Insurance on the Secondary Market

FOR SOME SENIORS with high net worth, the golden years have taken on a literal meaning. Thanks to a burgeoning secondary market for the purchase of life insurance policies by investment funds searching for competitive returns,[1] persons in their early 70s to early 80s, with relatively good health and at least several million dollars in assets (net worth is a criterion for how much life insurance a company will offer an applicant) have discovered an unexpected financial resource in their unused insurance capacity. Under the right circumstances, their purchase and later sale of life insurance, a new variation on senior life insurance settlements, can be very lucrative, realizing returns of double or even triple the investment over two years. For example, two years ago, a 75-year-old man with a certain actuarial life expectancy[2] could have paid two years of premiums in the amount of $500,000 for a $10 million life insurance policy and now, two years later, sell the policy net of fees for approximately $1.5 million.

The potential for gain should not, however, lead a senior to step blindly into any transaction that has complicated legal ramifications, as senior life insurance settlements typically do. The first step for counsel is to appreciate how the new transactions work and then to inquire about certain personal and financial questions. Although the transactions may take many forms, legal issues regarding insurable interest, disclosure, and taxes should always be examined. While guiding clients through the minefields, counsel can help them make knowledgeable decisions to further their financial goals.

To understand new life insurance settlement transactions, counsel should know the history of how they evolved. The secondary market for life insurance started with viatical settlements in the 1980s. A viatical settlement is defined in California as an agreement by which a person owning a life insurance policy upon the life of a person with "catastrophic or life-threatening illness or condition" sells the policy or the right to death benefits for an amount less than the policy's death benefits, except assignments to a licensed lender or credit union as collateral for a loan. In response to the AIDS epidemic, investors began purchasing the existing life insurance policies of persons who suffered from the illness and desired immediate cash to pay for end-of-life care. Like other states, California enacted consumer protections for the sellers of viatical policies and special licensing requirements for the purchasers.[3] As AIDS patients started living longer due to medical advancements, the market began to include third-party purchases of existing policies on the lives of people who were not necessarily in critical condition.[4]

Unlike the highly regulated viatical settlements, senior life insurance settlements, generally speaking, are treated legally as the sale of any insurance policy.[5] The third-party transactions that originated from viatical settlements then morphed into simply an alternative way for any senior, regardless of health, to sell a life insurance policy for more than the cash value that might be received from its surrender. It was estimated in 2003 that more than 20 percent of almost $500 billion of life insurance already in place for those over 65 had an economic value exceeding cash surrender value.[6]

RICHARD EWING

The growth of the secondary market has spawned a new type of insurance settlement, one in which a senior takes additional life insurance and actually anticipates, as one available option, the policy's subsequent sale even without a decline in the senior's health. The basic transaction is that the senior (alone or with a third party, who may or may not be a family member) "invests" in a policy[7] by paying two years of premiums. The policy insures the senior's life, the insurer is investment-grade quality,[8] and the death benefit is typically $5 million or more.

Then, if the senior chooses, depending upon future circumstances, the policy is sold after two years have passed. The significance of the two-year period is that life insurance policies in California, like those of other states, must contain a clause that they cannot be contested by an insurer after a period not exceeding two years from the policy's issuance, except for failure to pay premiums and situations that make the policy void ab initio.[9] A buyer in the secondary market typically wants an investment free of claims by the insurer that could oth-

Terry M. Magady is a certified elder law specialist practicing in Los Angeles.

Mr. Magady may be contacted at (310) 478-6543, tmagady @elderlaw.net or 11400 West Olympic Boulevard, Ninth Floor, Los Angeles, CA 90064-1557

erwise be brought prior to the expiration of the incontestability period. New health risks for the insured over the two years would also make the policy attractive in the secondary market.

How can there be such significant profit in a life insurance settlement, however, when the health of the insured does not decline? For the senior to buy low and sell high, so to speak, the insurer and the subsequent buyer clearly must have different analyses regarding an expected return from the policy. The insurance company's lower price is based upon an anticipated return that includes some percentage of policy lapses for nonpayment. The purchaser in the secondary market can pay a higher price, on the other hand, with the knowledge that it will not allow the policy to lapse and nullify its return. In addition, the discrepancy between the determination of value by the insurance company and the buyer in the secondary market may be attributed to differences of opinion on the actuarial life of the insured. Accentuating the price arbitrage, an agent with business acumen and a high dollar amount of insurance sales can negotiate a more favorable premium rate for the policy. If the insurer gives the senior a preferred rating, for example, that is built-in additional potential for profit on the later sale. Currently, there is significant competition for the policies in the secondary market.

There are also risks, as with any type of investment. Someone is basing a decision on the anticipated market two years after the policy's inception. Insurance companies could start raising the premiums on certain older age groups. The actuarial analysis of life expectancies could result in higher life expectancies due to new methodology. As interest rates rise, the secondary market could find more desirable investments, though the increase in interest rates may also result in a higher return on cash value. There are other economic circumstances that are difficult, if not impossible, to predict. To warrant this investment, one must conclude, after evaluation, that there will be some stability in the factors affecting the price arbitrage over a two-year period and that a well-negotiated purchase price at the policy's inception allows ample cushion for a change.

Though media attention has focused on investor involvement,[10] the most straightforward approach for the transaction is taken when the senior or family uses their funds for the first two years of premiums. The senior's existing life insurance may be a source of this funding through a loan, exchange, sale, or surrender, each of which will have an economic tradeoff that must be analyzed. The senior may take a short-term loan on the cash value in existing policies and then pay back the loan when the new policy is sold. If the new policy is better than the existing one (for example, larger death benefits for the same premiums or the same death benefits for smaller premiums), then the old policy could be surrendered for cash value or exchanged for the new policy using existing cash value or proceeds from another initial sale in the secondary market. The senior's children may also want to participate in paying for premiums or receiving a policy as a gift.

Requiring a review on a case-by-case basis, the transactions with investors, other than family, will undoubtedly undergo permutations in response to ongoing changes in insurance company application procedures. One popular approach in the past was for the investor to make the senior a nonrecourse loan secured by the policy for the senior's payment of the first two years of premiums and with an extra advance to the senior. In two years, the senior could choose to maintain ownership of the policy and pay back the loan or to keep the advance from the financier if the policy is transferred to the financier in exchange for the cancellation of the indebtedness. To the extent more life insurance application procedures dissuade applicants from borrowing, however, it will become more difficult for investors to participate through nonrecourse loans.

An alternative to loans is for the senior and the investor to form a limited liability company or a trust that is the owner and beneficiary under the policy. As members of the limited liability companies or beneficiaries of the trust, the investor and senior share the benefits of the insurance (in a sale or on death of the insured) depending upon how much either of them pay toward the premiums. Outright contributions, instead of a loan, may sometimes be treated more favorably in insurance company application procedures.

Two threshold personal issues must be examined before someone even considers the transaction. First, the senior must appreciate that, once any policy is sold, the ability to obtain additional life insurance will be limited to some degree depending upon the growth of the senior's net worth. Careful consideration must be given to anticipate if there are estate taxes or other special needs for which additional life insurance would be helpful. Of course, provided the senior can continue to afford the premiums, he or she may decide to maintain the insurance rather than sell a policy, a choice that is often more financially advantageous for heirs. The purchase of more than one policy with varied amounts of insurance may provide the senior with flexibility to keep, instead of sell, some insurance.

Second, the senior must of course feel comfortable that a stranger has a vested interest in his or her death. Any promised confidentiality for the name and address of the insured party may be breached, and the senior really has no control over where the investment will find its home. In Victorian England, wagering with maritime insurance and life insurance on strangers was prohibited due to public policy concerns about the gambler's accelerating, so to speak, the death benefits of policies.[11] Yet no one really expects money managers of hedge or pension funds to hire hit squads. To the extent it provides some solace, however, a named beneficiary who "feloniously and intentionally" kills the insured is not entitled in California to any benefit under the policy.[12]

If someone is comfortable with the personal and financial issues, then counsel can provide advice on the legal implications. No matter the format for the transaction, the key factors for analysis typically are insurable interest, disclosure, and taxes. The beginning legal inquiry is whether the policy owner has an insurable interest in the senior's life, and the consequences to the senior if there is no insurable interest.[13]

Insurable Interest

In California there is an insurable interest for a life insurance policy when the initial owner has a substantial interest engendered by love and affection in the case of individuals closely related by blood or law, or, alternatively, a reasonable expectation of pecuniary advantage through the continued life, health, or bodily safety of the insured and consequent loss by reason of death or disability.[14] Without an insurable interest, the policy is void.[15] The insurable interest is required when the insurance contract becomes effective, not at the time the loss occurs.[16] A life insurance policy may be transferred to any person,[17] whether or not the transferee has an insurable interest.[18] This, in essence, has enabled the operation of the strong secondary market for the policies.

The insurable interest is well established in situations in which the senior or the senior's family pays for the insurance without outside financial assistance. There is no doubt that the insured has an insurable interest in his or her own life.[19] Likewise, when a senior's spouse or children apply for the policy, they also have an insurable interest in the senior's life.[20] Certain business relationships may also create an insurable interest.[21]

Yet there is always some risk that life insurance financed by an investor may run afoul of insurable interest requirements. When a senior borrows money from an investor to pay for a policy, he or she owns it at inception and seemingly has an insurable interest in his or her own life. Even a creditor-debtor relationship is sufficient for an insurable interest, at least to the extent of the debt.[22]

Nonetheless, opining on a transaction in which the insured was given a recourse loan for the premiums and a "put" for the financier to buy the policy on a date certain, the Office of the State of New York Insurance Department concluded there was no insurable interest under New York law.[23] The department reached this conclusion, according to the opinion, because the policy was purchased "as a speculative investment for the ultimate benefit of a disinterested third party," which ostensibly New York's insurable interest requirement was enacted to prevent.[24] While the opinion was neither law nor necessarily well founded, many major insurance companies followed shortly afterwards with more extensive inquiries in applications about whether the applicant was obtaining a loan in connection with the policy and memoranda to their agents that they would not issue insurance on those who did. The structure of a limited liability company or trust with a contribution by the investor may satisfy application inquiries specifically about a loan, but, depending upon the allocation of a policy's benefits between the insurer and the investor, it is uncertain whether there is an insurable interest.

Even after the incontestability period expires, an insurance policy might still be challenged on the ground it is void ab initio for lack of an insurable interest.[25] The insurer is the only party who may challenge whether the insured had an insurable interest,[26] though in connection with its own liability an insurer is entitled to rely in good faith on whatever representations are made by an applicant for insurance relative to his or her insurable interest in the insured.[27] If the policy is rescinded, any consideration received by the insurance company, such as paid premiums, must be returned.[28]

When the transaction passes muster in the application phase, the senior who uses investor's funds to pay the premiums at the policy's inception is thus still taking some risk as a result of the insurable interest issue. The senior is betting that the insurer is unlikely to seek rescission upon the senior's death due to the insurer's prior knowledge of the financing structure in the application process,[29] as well as a supportable position for insurable interest where there are no legal bright lines.[30] While this may indeed be a reasonably calculated decision, what the insurer will do in the future is uncertain.

Disclosure

After insurable interest is addressed, another important legal issue is disclosure. Needless to say, an applicant must be truthful. An insurer may within two years rescind a life insurance policy for material misrepresentations in the application, regardless of whether they had a causal connection to the death of the insured. Materiality is determined solely by the probable and reasonable effect that truthful answers would have had upon the insurer.[31] Applicants should thus make as complete a disclosure as possible regarding financial aspects of the transaction as well as health.

For accurate disclosure, attention must also be focused upon the application, since by statute a life insurance contract consists of the policy form, the endorsements, and the attached application.[32] Unless the application is attached to the policy when delivered, however, no statement made in the application may be used as a defense to payment of benefits.[33] The application may ask whether the applicant intends to sell the policy.

In order at once to respond accurately and at least to anticipate the possibility of a sale, the applicant must really intend to maintain the policy for estate or other purposes when the application is submitted, notwithstanding the extant opportunity to sell it. The future decision to sell will depend upon yet unknown circumstances. If the estate continues to be the chief concern and cash for premiums is available, maintenance of a policy in fact is often the better financial decision. However, any formal arrangement, such as an option or a nonrecourse loan, weighs against an applicant's position that there is no intent to sell.

The applicant's risk from an insurer's challenge due to lack of disclosure, however, is significantly mitigated by the strength that courts have afforded the two-year incontestability clause. "The object of the clause is plain and laudable—to create an absolute assurance of the benefit, as free as may be from any dispute of fact except the fact of death, and as soon as it reasonably can be done," writes Justice Oliver Wendell Holmes in a seminal U.S. Supreme Court opinion.[34] To the benefit of the senior, any investor, and the ultimate buyer, U.S. and California courts have been wont to circumvent the public policy protection provided by the two year incontestability clause. This has been the case, for example, when there are grossly fraudulent statements on an application or even when an imposter was used for an applicant's medical exam.[35] Counsel should inform an applicant about the diligence insurers employ in the application process because they are aware of the seriousness of the two-year clause.

In addition to reviewing disclosure in the application, counsel must examine carefully any representations the senior may make to an investor at the policy's inception or a buyer when the policy is sold. Any contract with an investor or buyer may provide an opportunity to include disclaimers. Yet when there has been no investor involvement and there is a pending sale to an institutional buyer, the senior may be inclined to minimize changes in documentation out of concern for getting the best price possible for the policy's sale. Especially if there is investor involvement, however, counsel may consider providing in any sales agreement that the insured cannot make representations that really are legal opinions, such as those regarding insurable interest.

Counsel should also inform the senior that the applicant for the policy is not protected by the two-year incontestability clause with respect to actions by an investor or the ultimate buyer. The senior's representations thus can allow, in effect, certain recourse for the investor or buyer even when, for example, a loan itself is nonrecourse. If representations to an investor or buyer can be tailored to minimize liability, however, challenges to a policy based upon disclosures may generally be less problematic than those based on insurable interest. This is due chiefly to the established protection of the two-year incontestability clause for failure of disclosure but not necessarily for failure of an insurable interest.

Tax Issues

There are estate and income tax consequences to any of these transactions. Tax issues for the senior buying the policy without outside financial assistance often relate to the new policy's ownership or an existing policy loan, surrender, or sale to fund the new insurance. The senior must weigh who should apply for the policy. When an irrevocable insurance trust is the policy's owner, the sale proceeds or death benefit can, with proper estate planning, be sheltered from estate tax if the insured does not possess incidents of ownership.[36] When the senior is the owner, he or she has the opportunity, rather than only the heirs, for the personal use of the funds if the policy is sold. The sale proceeds (if the senior outlives the sale) or the death benefit (if the senior does not outlive the sale) would then be included in his or her estate for estate tax purposes.[37] There are consequences to delaying the ownership decision, since the policy will still be included in the senior's estate if the senior transfers it within three years of death.[38]

Due to anticipated taxable gain upon the policy's sale,[39] the senior should compare federal and state income tax for the sale by the irrevocable trust or the senior. Income tax on sale proceeds in the trust may be based upon compressed income tax rates for nongrantor trusts if the funds are held in the trust or the individual tax rates of the trust's beneficiaries if the proceeds are distributed.[40] Income tax on sale proceeds by the senior, on the other hand, are based upon his or her individual rate. Counsel should note that even wealthy seniors may have a relatively low tax rate if, for example, much of the net worth consists of investments that do not generate taxable income.

Depending upon how the existing policies are used, there are tax effects relating to the cash value. With regard to loans on the cash value, there is no deduction for interest when the proceeds are used to purchase other life insurance.[41] If surrender or sale is economically appropriate, seniors should appreciate that the lump sum payment from the surrender value of a policy generally is taxable as ordinary income to the extent it is greater than the premiums and other consideration paid.[42] No gain is ordinarily recognized on the exchange of an insurance policy for another insurance policy, endowment policy, or annuity.[43] In addition, there are special exclusions from gain categorized as "accelerated death benefits" if the insured is considered "terminally" or "chronically" ill.[44]

Particularly when a family member is involved in the transaction, it should be noted that the proceeds of the policy paid in a lump sum by reason of the death of the insured are generally excluded from the recipient's gross income.[45] However, if the policy has been transferred for value to a party other than the insurance company, such as that family member, the proceeds payable on the death of the insured will be subject to income tax.[46] This "transfer for value" rule does not apply if the transfer is a gift in which the transferee keeps the same income tax basis as the transferor.[47] A family member's participation in the transaction should thus be planned carefully to maintain when possible the tax-free status of the insurance proceeds.

There is at least one potentially significant unknown income tax risk in most cases when there is a nonrecourse loan secured by the policy. In order to guarantee a significant return in the event the insured dies within two years of the policy's issuance or the owner keeps the policy in lieu of its transfer after two years, the financier typically is owed origination charges and contingent interest that could be double or more of the amount of the loan for the initial two years of premiums and advance. The unpaid balance of a forgiven loan is included in computation of the amount a taxpayer realizes on sale even when the loan is nonrecourse.[48] While the senior anticipates paying taxes on the "fee" advanced above the amount of the premiums, it is unknown whether the forgiven charges and interest could be part of the amount realized in excess of the adjusted tax basis for the calculation of the gain.[49] One tax advantage of a limited liability company is the flexibility for the allocation of income tax gains and losses. In the limited liability company structure, the investor makes a contribution that is allocated as such on the books of the company. Neither a loan nor cancellation of indebtedness is necessary.

There will continue to be a public policy debate over whether the new financial opportunities for life insurance should be restricted in some way for perhaps an antiquated fear of a Dickensian villain.[50] Independently from polemics, counsel must advise regarding each transaction individually so the senior can appreciate legal and tax effects to assist with making a decision. Whether investor involvement remains viable will depend on the evolving insurance application procedures and regulatory environment. However, a senior's ability to buy and then sell his or her insurance product is difficult for anyone to inhibit. Nor should it be inhibited, particularly if these life insurance settlements can be profitable and if the senior is well informed regarding their ramifications. ■

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1 *See, e.g.,* Warren Buffet, Berkshire Hathaway, Inc., 2004 Annual Report, at 22 (2005).
2 While insurance companies do their own actuarial analysis, independent companies make a determination of life expectancies used in connection with the sale of policies in the secondary market.
3 *See generally* INS. CODE §§10113.1 *et seq.*
4 Neil Doherty & Hal Singer, *The Benefits of a Secondary Market for Life Insurance Policies,* 38 REAL PROP. PROB. & TR. J. 452 (2003) (hereinafter Doherty & Singer); *see also* INS. CODE §10113.1(a)(1).
5 California has minimal advertising and disclosure requirements for life insurance sold to persons 65 and older. INS. CODE §§787, 789.8(a). Agents may be subject to claims of elder abuse for misleading clients. *See* WELF. & INST. CODE §§15600 *et seq.*
6 Doherty & Singer, *supra* note 4, at 452.
7 The policy typically is universal life insurance, which resembles ordinary whole life insurance except there are flexible premiums.
8 Five prominent rating systems for financial strength of insurance companies are: A. M. Best Company, Standard & Poor's, Moody's, Fitch Ratings, and Weiss Ratings.
9 INS. CODE §10113.5; Paul Revere Life Ins. Co. v. Raoul G. Fima, 105 F. 3d 490, 491 (9th Cir. 1997).
10 Rachel Emma Silverman, *Letting an Investor Bet on When You'll Die,* WALL STREET J. (May 26, 2005).
11 *See* discussion of 19 Geo. II c. 37 *and* 14 Geo. III c. 48 *in* Conn. Mutual Life Ins. Co. v. Schaefer, 94 U.S. 457, 460 (1877).
12 PROB. CODE §252.
13 "[A]bsent statutory pronouncement, insurable interest in the context of life insurance is difficult to define with precision, as, in the effort to avoid wagering policies, no clear rule has been established by the court." COUCH ON INSURANCE §41:17 (3d ed. 1995).
14 INS. CODE §10110.1(a). There is an exception for charities. INS. CODE §10110.1(f).
15 INS. CODE §10110.1(e).
16 INS. CODE §10110.1(d).
17 Estate of Ferrero, 142 Cal. App. 2d 473 (1956).
18 INS. CODE §10130. *See also* Grigsby v. Russell, 222 U.S. 149, 154 (1911), in which Justice Oliver Wendell Holmes distinguishes the public policy concern over granting "a general license to all to insure whom they like" from the policyholder's right to transfer the policy "to one whom he…is not afraid to trust."
19 INS. CODE §§10110(a) & 10110.1(b).
20 *See, e.g.,* Turner v. Metropolitan Life Ins. Co., 56 Cal. App. 2d 862 (1st Dist. 1943).
21 *See* INS. CODE §§10110.1(c) *and* 10110.4 regarding an employer's insurable interest in directors, officers, employees, and others or in connection with the reacquisition by shareholders of shares or the primary obligor of a contract guaranteed by the employer.
22 Curtiss v. Aetna Life Ins. Co., 90 Cal. 245, 251 (1891). The extent of a creditor's insurable interest may be limited to the sum of the amount of the debt, the refund of the initial premium, and interest on these two amounts. Jimenez v. Protective Life Ins. Co., 8 Cal. App. 4th 528, 541 (1992).
23 Offices of General Counsel, State of New York, Insurance Department, Op. Re: Life Insurance Transactions (Dec. 19, 2005).
24 *Id.*
25 INS. CODE §§280; 10110.1(d); Paul Revere Life Ins. Co. v. Raoul G. Fima, 105 F. 3d 490, 491 (9th Cir. 1997).
26 *See* Marriage of Bratton, 28 Cal. App. 4th 791, 793-94 (1994).
27 INS. CODE §§10110.2.
28 Imperial Cas. & Indem. Co. v. Sogomonian, 198 Cal. App. 3d 169 (1988).
29 Whether estoppel or waiver is sufficient to avoid rescission for a lack of insurable interest for life insurance in California is uncertain. Some other states hold that insurer's actions and knowledge may be a waiver of the defense of insurable interest or estoppel from asserting it, while some do not. COUCH ON INSURANCE 3d §41:8. *See also* 86 A.L.R. 4th 828.
30 The statutory examples of insurable interest are not exclusive. INS. CODE §10110.1(g).
31 INS. CODE §334; Freeman v. Allstate Life Ins. Co., 253 F. 3d 533, 536 (9th Cir. 2001).
32 INS. CODE §10113.
33 Telford v. New York Life Ins. Co., 9 Cal. 2d 103, 106 (1937).
34 Northwestern Life Ins. Co. v. Johnson, 254 U.S. 96, 101 (1920).
35 *See* Amex Life Assurance Co. v. Superior Court, 14 Cal. 4th 1231 (1997).
36 I.R.C. §2042; Treas. Reg. §20.2042-1(c)(2). *See also* William R. Burford, *Irrevocable Life Insurance Trusts,* LOS ANGELES LAWYER, May 2006, at 40.
37 I.R.C. §2042; Treas. Reg. §20.2042-1(c)(2).
38 I.R.C. §§2035(a), 2042.
39 *See* Priv. Ltr. Rul. 94-43-020 (July 22, 1994) regarding taxation of a viatical settlement.
40 *See* I.R.C. §1(e) (trust rates) *and* I.R.C. §§1(a)-(d) (individual tax rates).
41 I.R.C. §264(a)(3).
42 Bodine v. Comm'r, 103 F. 2d 982, *cert. denied,* 308 U.S. 576 (3d Cir. 1939).
43 I.R.C. §1035(a).
44 I.R.C. §101(g).
45 I.R.C. §101(a).
46 I.R.C. §101(a)(2).
47 I.R.C. §101(a)(2)(A); Treas. Reg. §1.72-11(b)(1).
48 Treas. Reg. §1.1001-2(a)(1) and (4)(i); Commissioner v. Tufts, 461 U.S. 300 (1983).
49 While a private letter ruling recognizes that interest not deducted is also not included in determining gain for real estate, no one can be assured a court would determine likewise, with respect to life insurance or otherwise. Priv. Ltr. Rul. 92-51-023 (Dec. 18, 1992).
50 *See* Charles Dickens, *Hunted Down,* NEW YORK LEDGER (1859) (An insurance office manager ensnares cunning poisoner Julius Slinkton.).