THE LIFE SETTLEMENT INDUSTRY – BANKRUPTCY ISSUES - PART 1

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A “life settlement” is the sale of a life insurance policy to a third party for a value in excess of the policy's cash surrender value, but less than its death benefit. The life settlement industry focuses on the purchase and sale of life settlements or fractional interests in life settlements to investors. These investors may be anyone from individuals to groups of investors, hedge funds or other institutional investors. How these interests are sold to investors, what type of documentation is provided, what representations are made, and how the interests are reflected on the books and records of the insurance company, all come into play if the life settlement company enters bankruptcy.

I last wrote about the pitfalls of life settlement investments in the event of a bankruptcy from the creditor’s point of view. Now it’s the debtor’s turn. A life settlement company becomes a debtor when it files a bankruptcy case. In a Chapter 7 (liquidation) case, upon filing a trustee is appointed with specific duties as enumerated in the Bankruptcy Code. These duties include collecting and administering the assets of the debtor’s estate for the benefit of the debtor’s creditors. In a Chapter 11 (reorganization) bankruptcy case, unless a trustee is specifically appointed, the debtor’s management remains in control of the debtor-company during the chapter 11 case and has duties similar to that of the Chapter 7 trustee. In the life settlement industry, in addition to the sale of beneficial interests in life settlements, the critical focus of a life settlement company is on retaining sufficient funds to pay premiums as they come due --- which need to be made for many years or even decades for each policy --- in order to avoid the policies going into grace (i.e., the period of time past the premium payment due date wherein the policy owner is generally given additional time to provide payment without the policy lapsing).

Having represented both Chapter 11 debtors and Chapter 7 trustees in life settlement bankruptcy cases in recent years, I’ve seen the spate of issues unique to this industry, including (1) are the life settlements assets of the debtor’s bankruptcy estate?; (2) what type of interest (if any) do the investor creditors have in the life settlements?; (3) how can the interest of the investor creditors in the life settlements best be determined?; (4) are the life settlements viewed as securities under applicable state law?; (5) how can the debtor-in-possession or trustee avoid the life settlements going in to grace and/or lapsing due to insufficient funds to make premium payments?; (6) can the life settlements be used as collateral for a debtor-in-possession (“DIP”) loan to keep the business operating if/when revenues slow?; (7) should the life settlement policies be sold or maintained?; (8) if some or all of the policies should be sold, what is the most effective process?; and (9) how can a life settlement company emerge successfully from bankruptcy? Over the next several months I will address each of these issues separately, beginning here with issue (1).

Are life settlements assets of the debtor’s bankruptcy estate? Under the Bankruptcy Code, the filing of a bankruptcy case creates an estate. The Bankruptcy Code defines the term “estate” very broadly to include “all legal or equitable interests of the debtor in property as of the commencement of the case.” It also includes additional interests, such as property the estate acquires after the commencement of the case and property the estate recovers (such as in litigation). If the debtor is listed as the owner and/or the beneficiary of a life settlement on the books and records of the insurance company, that policy will be included as an asset of the

bankruptcy estate. That determination does not, in and of itself, mean that the debtor owns the policies – it simply means that the debtor has a legal or equitable interest sufficient to be included in the bankruptcy estate. If the debtor is not listed as the owner or beneficiary of a life settlement, but is the agent or escrow agent of the owner and/or beneficiary, the determination may not be as clear-cut. The bankruptcy court may then have to determine whether the life settlements are, or are not, part of the bankruptcy estate and thus subject to the court's jurisdiction.

The determination of whether or not the life settlements are part of the bankruptcy estate is critical, as the bankruptcy court does not have jurisdiction to make determinations on property that is not part of the bankruptcy estate. Moreover, the debtor's interest in the life settlements is closely related to the issue to be discussed next time: What type of interest (if any) do the investor creditors have in the life settlements?

For more information on this topic, please contact the author, Deborah Talenfeld, on the firm's Business Reorganization Team.

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