THE LIFE SETTLEMENT INDUSTRY – BANKRUPTCY ISSUES – PART 3

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This third installment of our series delves into the following issues: (1) Are life settlements viewed as securities under applicable state law? (2) How can the debtor-in-possession, i.e. the debtor in a Chapter 11 bankruptcy case ("DIP") or the trustee avoid the life settlements going in to grace and/or lapsing due to insufficient funds to make premium payments? (3) Can the life settlements be used as collateral for a DIP loan to keep the business operating if/when revenues slow?

Almost all states treat life settlements as securities under state securities law, either by defining life settlements as securities explicitly or by finding them to be securities under the investment contract analysis established by the U.S. Supreme Court in SEC v. W.J. Howey Co., 328 US 293 (1946). Under Howey, the dispositive test of whether a life settlement is an investment contract (and therefore a security) is "whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others." If a life settlement is a security, then it's subject to registration and regulation under state securities law. We suggest you refer to your state's securities law on this issue. Helpful information on this topic is also available on the SEC's website (www.sec.gov).

The two issues of (i) how the DIP or trustee can avoid the life settlements going in to grace and/or lapsing due to insufficient funds to make premium payments, and (ii) whether life settlements can be used as collateral for a DIP loan to keep the business operating if/when revenues slow, are intertwined. When a DIP or trustee is faced with a situation where policies will lapse if premium payments are not made, a solution must be found immediately to save the value of the policies. The first hurdle is to find out exactly when each policy will go into grace and then lapse. "Go into grace" refers to the grace period when a premium payment is late but the policy has not yet lapsed. The grace period is usually 30 days. To avoid the policy from going into "lapse pending" (a second period of time whereby notice is given that the policy will lapse, i.e., terminate, if the premium due is not paid) all outstanding premiums must be paid before the grace period expires. Once the policy goes into lapse pending, premium payments must be brought up to date to avoid lapse (i.e., the policy has terminated), which is usually another 30 days. A good rule of thumb is that you have about 60 days from grace to lapse to save the policy from lapsing.

The DIP or trustee must then determine the cash value of each policy, as well as prepare a list of upcoming scheduled premium payments. Notably, it is not always critical to make a scheduled premium payment on a policy on the due date, or in the amount scheduled. There is often a cash value component of the policy that can be used to offset all or a portion of upcoming premium payments. Premium payments may incorporate not only amounts for the life insurance component of the payment, but also funds to increase the cash value, something not essential when trying to prevent policies from lapsing. The debtor or trustee must "optimize" premium payments, i.e., pay premium payments equal to the amount necessary to keep the policy out of grace or lapse. Another definition is that policy premiums be paid in an amount and frequency sufficient to keep the policy in full force and effect at all times while not increasing the policy accumulation amount or cash surrender value. Excessive premium payments (such as those that increase the cash value) will only increase the value of the policy to future policy holders, and will not assist the current owner of the policy, i.e., the DIP or trustee.

It is advisable to consult an expert in the field to assist with the analysis of how best to optimize premiums.

The second hurdle is to determine the value of each policy. In order to reach this goal, it will be necessary to obtain updated Life Expectancy ("LE") reports on each of the insureds under the policies in question. A life expectancy is a statistical calculation that indicates the average length of life left until death that is expected for an individual with a known mortality risk profile. The most important factors are demographics (age, sex and race), personal attributes and personal history. The more that is known, the more accurate the life expectancy calculation. An LE report is an essential component to determining the value of a policy. The LE of an insured can vary over the life of a policy, depending on the health of the insured and other factors. It is important to ascertain whether an insured has signed releases under HIPPA ("Health Insurance Portability and Accountability Act of 1996") law, agreeing to make all medical records available to the buyer and new owner of the policy. If a HIPPA release cannot be found, do not hesitate to reach out to the insured to obtain a copy of this release. It is important and it will be very difficult to obtain recent medical records without a HIPPA release. Again, it is advisable to consult an expert in the field to assist with this analysis.

Once the updated LE report is obtained, it will be necessary to analyze all data to come up with the fair market value of the policy or policies in question. All policy documents should be gathered, as the value of a policy can be increased by fully documenting the policy. Examples of necessary documents include, but are not limited to, a copy of the policy including any amendments, current illustrations, medical records of the insured, all correspondence relating to the policy, and other applicable documents. It is advisable to consult an expert in the field to assist with the analysis of the value of the policy in question.

Once the DIP or trustee has the information available to ascertain the optimized premium amount and value of the policy, the fiduciary in question can determine whether it makes sense to pay future premiums on that policy. If the policy has a low value because of a high LE report (i.e., the insured's life expectancy is long) or other reasons, it may be better to let the policy lapse.

If there is no cash in the bankruptcy estate to pay premium payments, then the fiduciary will need to evaluate other options. One option is to obtain a DIP loan or trustee in possession loan as a source of funds to pay premium payments. In this scenario, the fiduciary of the estate will need to determine whether a loan is advisable based on the value of the policy and the cash needed to make premium payments based on the optimized premium payments to be made. If a loan is contemplated, then the fiduciary will also need to consider the cost of such a loan. The strength of the policy value will affect the cost of the loan, which will undoubtedly incorporate an above-market interest rate. It is important to determine whether the policy has enough value in it to warrant the cost of a loan against that policy.

A fiduciary loan is often sought using a portfolio of policies as collateral. In that circumstance, the value of each individual policy may not be as much of a concern, as the lender will be looking at the entire portfolio as its collateral. Further, the fiduciary may want to drop any under-value policies so that payment of premiums on those policies does not create unwarranted debt against the overall portfolio. The premium outlay on policies can drain cash out of a bankruptcy estate and must be closely monitored.

Next time we will discuss (1) whether the life settlement policies should be sold or maintained and, (2) if some or all of the policies should be sold, what is the most effective process.

For more information on this topic, please contact the authors, Leslie Gern Cloyd and Deborah Talenfeld, on the firm's Business Reorganization Team.

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