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Unneeded Key-Person Policies And The Secondary Market

Many small- and medium-sized businesses have one person critical to the organization, without whom the company would falter. In order to safeguard the human and financial assets of the business, key-person policies are often purchased for protection should this executive prematurely die, retire or suddenly leave the organization.

When an insured key-person retires or resigns, the company typically cancels its corporate-owned policy and takes the cash-surrender value, if any is remaining. Life settlements (also known as high-worth transactions) offer the company a new and attractive option: Sell the policy, be rid of any future premium obligations, and receive a lump sum of cash well above the cash-surrender value.

Key-Person Policies Generate Cash

Life settlements provide companies a strategy to deal with several possible scenarios. In some cases, a leading employee will retire, and the company may offer to transfer ownership of the key-person policy to the retiree. Such an offer is often declined, because the retiree does not want the obligation of making high premium payments.

There may also come a time when the key-person policy is no longer needed, as the executive may become less critical to the business because the aptitudes of other executives have improved or the business is sold.

When a business merges with or is acquired by another, key-person policies often become assets of the new entity. Indispensable executives of the acquired business may not be so valued in the new business.

In the past, companies facing these scenarios were left with only three options, depending on the type of policy: (1) recover some of the investment and surrender the policy for its cash value; (2) allow it to lapse, and write off years of premium payments as a necessary but unrecoverable business cost; or (3) continue to pay premiums on the policy until the death of the insured person.

A better alternative for the company is to investigate the advantages of selling the policy through a life settlement broker. If it is a policy with cash value, the sale may provide more than the cash value. If it is a term policy that qualifies for sale, funds can be obtained from a policy that previously had no intrinsic value.

How Life Settlements Work

Life settlements are based on the proposition that some insured individuals no longer want, need or can afford their coverage. Instead of selling the policy back to the issuing insurance company at less-than-market value or allowing the policy to lapse and forfeiting the value, life settlements allow another exit option that can maximize the cash value for the policy owner. Consequently, life settlements have quickly developed into a viable and attractive alternative cash management strategy.

In a nutshell, the life settlement process

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involves a life insurance policyholder selling the benefits of the policy to an investor. Most investors do not directly negotiate with policyholders; rather, they provide financing for life settlement companies that facilitate the buying of the policies. According to a June 5, 2003, article in *USA Today* ("CEO Life Insurance as an Investment?"), approximately 25 percent of key-person policies can be sold to institutional investors in the secondary market.

Policies considered for purchase by life settlement companies must meet certain eligibility requirements:

- ✔ The policy must be beyond any carrier or statutory contestability period, fully renewable, and subject only to the payment of premiums.
- ✔ The insured's life expectancy must be between 25 and 144 months, based on one or more medical evaluations from an approved evaluator.
- ✔ Term policies must have a minimum term life insurance coverage equal to the greater of two times the life expectancy or 10 years.
- ✔ The face value of such policy cannot exceed $20 million.

If the business accepts the life settlement company's offer, the business relinquishes ownership and beneficial interest in the policy in exchange for a cash payment. As the new policyholder, the investor must maintain all premium payments in order to keep the policy in force. The concept is much like the buying and selling of mortgage contracts—in this instance, an insurance contract is bought and sold with the investor acquiring both the beneficial interest in the contract and the obligation to provide for servicing and administration of the contract.

The market opportunity exists primarily as an alternative to surrender values, which are often so low that a qualified life settlement provider company can pay a higher value.

Finding the Right Life Settlement Company

Policy owners should insist their agents and brokers perform due diligence by gathering information from several competitive life settlement companies, targeting those whose senior management has had the most life settlement experience. German company Scope Group rates and ranks life settlement companies, the first and so far only company to do so, and offers information at *www.scope-group.com*. The settlement broker or agent should seek companies with an A- rating or higher.

A Rapidly Growing Industry

The future looks good for the life settlement industry, which has grown significantly in recent years. The Life Settlement Institute released statistics in April 2005, indicating life settlements have paid life insurance policy owners an aggregate of more than $1 billion over cash surrender for their policies.