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by Larry Simon

Life Settlements: Means for Cashing In Key-Person Policies

For many small and medium-sized businesses, there is one person who keeps the company afloat. If that person leaves, the business sinks. To protect the company should this executive prematurely die, retire or suddenly leave, companies frequently purchase "key-person" policies.

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

The practice has become widespread: the Life Settlement Institute reported last April that to date, life settlements have paid life insurance policy owners an aggregate of more than $1 billion over surrender value for their policies.

When Settlements Are Useful

Life settlements can assist companies in dealing with several possible scenarios:

- On retirement of a key employee, the company may offer to transfer ownership of the key-person policy to the retiree. Such an offer is often declined, because the retiree doesn't need the policy or the obligation of making high-premium payments.
- The key-person policy is no longer needed because the key executive becomes less critical to the business as the skills of other executives improve 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. Key executives of the acquired business may not be key executives in the new combined entity.

In the past, companies facing these situations had three choices, 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 until the death of the insured.

A better alternative may be to investigate 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, the policy may still be sold, creating a means for realizing funds 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 can maximize the cash value for the policy owner.

How do they work? In a nutshell, a life insurance policyholder sells 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 buying the policies. One published report says 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, such as:

- 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 coverage equal to the greater of two times the life expectancy, or 10 years; and
- the policy's face value cannot exceed $20 million.

A company accepting the life settlement company's offer 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 to keep the policy in force.

The concept is much like buying and selling 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 its servicing and administration.

The market opportunity exists primarily as an alternative to surrender values payable by life insurance companies when a policy owner decides to redeem or cash in the policy. These surrender values are often so low that a qualified life settlement provider company can pay a higher value.

Policy owners should insist that their agents and brokers perform due diligence by gathering information from several competitive life settlement companies. A German company known as Scope Group (*www.scope-group.com*) has become active in rating and ranking life settlement companies; brokers or agents should seek companies with an A- rating or higher.

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