



When Business Situations Change, Life Settlement Opportunities Arise

The most common business situation that can initiate a prospective life settlement is when an owner exits the business through retirement or a lifetime buyout.

Peter N. Katz, JD, CLU, ChFC

Life settlements are often considered a personal insurance and estate planning tool by financial service professionals and are sometimes overlooked by those who specialize in the areas of business insurance and executive benefits. Yet business and executive benefit situations are very frequently the catalyst for life settlement cases because a change in business personnel or in the condition of the business itself can cause a decreased need for life insurance. If some or all of the life insurance might otherwise lapse or be surrendered, a life settlement should be considered as a method of obtaining additional value for these policies.

When an Owner Leaves

Perhaps the most common business situation that can initiate a prospective life settlement is when an owner exits the business through retirement or a lifetime buyout. Frequently, the business will have a key person insurance policy in place that was purchased to offset the loss that would have been sustained by the business had this person died prematurely. In addition, the policy proceeds could be used to fund a buyout of the owner's interest in the business. Many buyouts are set up as cross-purchase arrangements, so it is fairly common to find policies that are no longer needed in the hands of co-owners as well.

While in some instances the exiting business owner will have a use for some of the coverage, a significant portion of the insurance may no longer be needed. Another factor that makes retention of the existing coverage difficult, if not impossible, is that a very large percentage of policies bought for buy-sell arrangements and key person needs are term insurance. So in addition to having a decreased need for coverage, the rising cost of the term insurance may be quite unappealing, if not altogether unaffordable, especially for an aging retired business owner.

A Living Buyout

In a recent case, the 74-year-old founder and, at the time, one-third owner of a large successful manufacturing business retired. The company owned \$5 million of term insurance on his life that had been acquired some years before. Prior to simply letting the policy lapse, upon the suggestion of a financial adviser, a life settlement was explored and it was determined that

About Life Settlements

What is a life settlement?

A life settlement is the sale of an existing life insurance policy that is no longer needed, wanted, or affordable, to a third party, usually an investment company, for an amount greater than would be received if the policy were lapsed or surrendered. Life settlements, by creating a secondary market for unwanted insurance policies, have evolved into an innovative, creative, and efficient way to maximize the value of these policies.

What types of policies qualify?

Most any type of policy is eligible including term, universal life, whole life, variable life (requires a broker-dealer), survivorship, and even group term, if convertible.

Who are the most likely candidates?

The most likely policies to gain additional value through a life settlement are on insureds age 65 and up, especially if they have had a decline in health since the policy was written.

How does a life settlement differ from a viatical settlement?

The precise definition varies from state to state as the current legislation lacks uniformity. For the most part a viatical settlement is defined to be the sale of a policy on a person who is terminally ill; usually, this means a life expectancy of less than 2 years. A life settlement is the sale of a policy on a person who is *not* terminally ill. Typically, the insured in a life settlement transaction has a life expectancy of between 5 and 15 years.

the policy could be sold for approximately \$1 million. The proceeds helped the company complete the buyout of the retiring founder.

A life settlement of this policy could have been just as valuable had the arrangement been set up as a cross purchase because the co-owners could have similarly used the proceeds to help fund their purchase of the retiring owner's interest. For this company there was also a collateral benefit; the

which owned \$4 million of key person term insurance on his life. The retiring owner wanted and could afford to keep only \$1 million of coverage. His health, having somewhat declined since the policy was bought, meant that new coverage was not an attractive option. The policy was split up, with the insured keeping \$1 million and selling the balance in a life settlement for \$400,000. The sales proceeds allowed him to afford a conversion to permanent insur-



life settlement proceeds left the company's balance sheet and cash-flow situation in a healthy enough position so it could expand. Shortly thereafter it acquired a smaller company, which probably would not have been possible if the company was strapped with an additional \$1 million obligation to a former owner.

Keep Part, Sell Part

A life settlement can also be valuable in situations where there is still an insurance need but it has decreased. Another recent case involved a retiring business owner who sold his business,

ance with funds left over to supplement his retirement income.

Life Insurance Retirement Plans

Life settlement opportunities exist beyond buy-sells and key person insurance. When a successful physician retired 2 years ago, his qualified plan owned a \$1 million whole life insurance policy on him. At first he "bought" the policy from the plan after borrowing out the cash value, intending to keep up the insurance through dividends and interest payments. When the dividend scale was reduced, it soon became clear

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- Are there topics that you feel don't get enough coverage, that you'd like to bring to the attention of other members?

Then we encourage you to submit articles for possible publication in this newsletter! Manuscripts or proposals for articles can be submitted to Editor Doug Brisco, who will review them for suitability for publication. Doug's contact information appears on page 7.

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We look forward to receiving your contributions! ■



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that the costs to carry the policy were going to be burdensome. In a life settlement transaction the doctor was able to net \$125,000 and be free of the loan, interest, and premium payments. Additionally, he used a portion of the proceeds for a long-term care policy on his wife.

Bankruptcy

Sometimes a business misfortune drives a life settlement transaction. The 69-year-old founder and major stockholder of the 35-year-old company he had taken public found himself in the unpleasant position of having his company subjected to reorganization in bankruptcy when market conditions and foreign competition drastically undercut his business. His remaining stock in the company was now nearly worthless and, although retained as an

adviser, he was replaced as CEO. In addition to a number of company-owned policies being dealt with in the bankruptcy proceedings, he personally held some \$20 million of insurance that had been paid for by the company through a bonus arrangement. Dictated by his new life situation, he no longer wanted or needed these policies personally but rather was looking for cash to help maintain his lifestyle. These universal life policies had approximately \$2.8 million of cash surrender value. A life settlement brought him \$6 million and the ability to continue living in the manner to which he had become accustomed. The company-owned policies could also be settled some time in the future as the bankruptcy reorganization proceeded.

Deferred Compensation and Split-Dollar Plans

Life-insurance-funded executive benefit arrangements, such as deferred compensation and split-dollar plans, are also often drastically impacted by the departure of a key executive or business owner. While policies bought for deferred compensation plans are often, but not always, retained to pay benefits or reimburse the company for those payments upon death, in some situations a life settlement may be a more attractive option.

Split-dollar plans that were intended to be rolled out with minimal tax consequences may no longer be given such favorable tax treatment. In addition, those policies may not be as attractive to keep as economic benefit costs escalate through age and less favorable government term rates. Finally, Sarbanes-Oxley concerns can cause the abandonment of split-dollar plans on senior executives of public corporations. A life settlement can provide an exit strategy previously unavailable or allow an exit from

the split-dollar arrangement to occur earlier than originally planned.

Conclusion

Because the life insurance policy acquisitions that result from a business enterprise can extend far beyond business-owned policies, it is important for financial advisers to cast a wide net in their search for policies that may require reevaluation when circumstances change. In addition to key person situations, other arrangements, such as pension and profit-sharing plans, cross-purchase agreements, creditor-assigned policies, and executive benefit and bonus programs are impacted by changing business situations. Even personally owned or trust-held policies for estate liquidity can be impacted as well. Should it be determined that all or a portion of the life insurance coverage is no longer needed, wanted, or affordable, a life settlement should be considered.

When businesses change hands, are subject to changes in their organization, or have owners or executives who retire, there are frequently life insurance policies around that were purchased for purposes or needs that cease to exist or are simply unaffordable. Where there are no longer reasons or the ability to keep all or a portion of those policies, a life settlement should be investigated to determine whether additional value can be derived from them.

Note: Case examples for this article have been modified to improve readability and protect privacy. ■

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The Society Welcomes Douglas E. Brisco as the New Editor of *Business & Compensation Planning*

The Society is pleased to announce the appointment of Douglas E. Brisco, JD, LLM, CLU, ChFC, to the position of editor of the *Business & Compensation Planning* section newsletter.

Doug is second vice president of Lincoln Financial Distributors' Advanced Sales department in Hartford, Conn. He received his JD from The University of Connecticut School of Law and his LLM in Taxation from Boston University School of Law. Prior to joining Lincoln, Doug was a member of the Advanced Marketing department at Phoenix Life Insurance Company. He also worked in the Trusts and Estates department of a major New England regional bank, as an estate planning, tax, and probate attorney in private practice, and for "Big Eight" accounting firms.

Welcome aboard, Doug!

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