Document hosted at JDSUPRA™
http://www.jdsupra.com/post/documentViewer.aspx?fid=9abc15a9-63eb-4736-98b2-82900e9dde51

The life insurance world is in a bit of turmoil these days over a practice associated with the sale of existing life insurance. Illustrated by the example of the individual in possession of a life insurance policy, perhaps acquired years ago under circumstances which no longer exist. A vibrant market has emerged via which that individual may be able to sell the policy to a third party. Once the third party buys the insurance policy, that third party is now responsible for premium payments, and when the insured dies, the third party collects the death benefit. The concept was born in the 1990s in response to situations involving people diagnosed with a terminal illness, typically one in which death was expected within 12 months, a process commonly known as a ***Viatical Settlement***. However, the financial world quickly recognized that the concept could be applied, in theory, to any existing life policy, and the broader application of the process emerged commonly known as a ***Life Settlement.***

Most would agree this activity began as a noble idea. The Viatical Settlement could provide much needed liquidity during a medical crisis for a person who may not have the funds necessary to get care in the face of a terminal condition. Even the straight Life Settlement offers a desirable economic solution to someone whose financial circumstances, and need for life insurance, has changed. The ability to achieve these positive results has been recognized for a very long time under the American legal system. The legal scholar Oliver Wendell Holmes, writing the 1911 US Supreme Court opinion in *Grigbsy v. Russell,* established important life insurance principles. The essence of Justice Holmes' decision is two fold: one, a life insurance policy has all of the typical characteristics of property, and as such represents an asset that a policy owner can transfer; and two, the policy must, when issued, be based on an "insurable interest." The insurable interest concept actually means that the policy owner has an interest in the insured life continuing. The contrasting view, that is a lack of insurable interest, renders the insurance policy to be little more than a wager, with the owner of the policy hoping that the insured will die sooner, rather than later.

The situation creating the turmoil within the industry is not the Viatical Settlement or the Life Settlement process, but the expansion of the life insurance settlement concept to the point at which people are now being recruited to purchase policies and then assign them to third parties. Members of the Doherty Estate and Financial Planning Society have been approached about this activity and it is widespread in areas in which large numbers of retirees can be found. The standard approach is for the "recruited insured" to purchase a policy on his or her own life with funds provided by the third party, and the third party is designated as the policy's beneficiary. Everyone has an insurable interest in his or her own life, so that requirement outlined in *Grigbsy v. Russell* has been met. The third party provides the funding for the premium payments for the next two years, after which ownership of the policy is then formally transferred to the third party. The reason for the two-year wait is that all life insurance policies sold in North American have a two-year "contestability" clause. The operation of this clause allows the insurance company a period of time to determine that all information on the application is true and accurate, and that no fraud has been committed in the acquisition of the policy. Once the two years has passed, the general rule is that the issuing life insurance company has no recourse against anyone, and is obligated to pay the death benefit upon the death of the insured assuming all premium payments have been made.

Document hosted at JDSUPRA™
http://www.jdsupra.com/post/documentViewer.aspx?fid=9abc15a9-63eb-4736-98b2-82900e9dde51

The insurable interest test needs to be met only when the policy is issued -- the future loss of insurable interest does not void, or otherwise affect, the policy. It is these very points the "recruiting settlement merchants" have seized upon to start this activity.

At least two problems are presented in these "recruiting arrangements." The first is the pricing of life insurance generally. A little known fact is that most life insurance policies never pay any death benefit. Simply because in term life insurance contracts, most insureds live through the term; and, in permanent life insurance contracts, most policies lapse. The consideration of the lapse ratio figures prominently in the pricing offered by companies in extending insurance to new applicants. If significantly more policies trigger the payment of death benefits, then the insurance industry will be required to significantly increase premiums for new life insurance coverage. The second problem is that life insurance is entitled to very significant tax advantages under the *Internal Revenue Code.* These advantages are undoubtedly predicated upon the belief that the life insurance industry is beneficial to society and to the economy because it provide citizens with access to an important financial tool. If the practice of flipping third party sponsored life insurance transactions is looked upon unfavorably by the United States Congress, the tax advantages of all life insurance may be threatened.

It is my view that this practice is unlikely to last because of these overriding concerns. The practice has drawn the attention of some industry regulators, as evidenced by recent action in the North Dakota State Senate. Also, the National Association of Insurance Commissioners has weighed in against the process. More regulatory entities are sure to follow. Furthermore, the insurance industry itself has become pro-active in this area, as many companies now require the agent writing the policy to affirm that the policy is not being sold to flip to a third party. Also, some companies have stated that if it uncovers during the two-year contestability period that the life insurance policy is to be flipped to a third party, it will void the policy.