

Bankruptcy Law

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Life Settlements

Discovering the Hidden Value of Life Insurance Policies: Application of Life Settlements in the Context of Bankruptcy



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With the current economic realities, trustees and debtors-in-possession (“DIP”), typically with oversight by both secured and unsecured creditors, are proactively managing the assets in the bankruptcy estates they are administering to maximize values in order to provide a meaningful distribution to creditors. To further this goal, practitioners are discovering new and creative ways to monetize “nontraditional” estate assets. One historically overlooked class of estate assets—life insurance policies—can yield significant returns to creditors if properly managed, and bankruptcy professionals are just beginning to understand how to unlock the policy’s value by marketing and selling such policies

through life settlements. Recent trends demonstrate that, where trustees and DIPs successfully monetize a debtor’s interest in life insurance policies owned by the debtor—regardless of whether the insured is (i) the debtor, (ii) the debtor’s employee or (iii) an individual wholly unrelated to the bankruptcy case—the potential market values can dwarf the policy’s then-existing cash surrender value (“CSV”). Consequently, practitioners should ensure that the necessary focus is applied to unlock the potential value of these all too often neglected assets.

Corporate-owned life insurance policies, also known as “key person” policies, have traditionally been viewed as a contingent asset, *i.e.*, the policy has no value until the key person dies. Typically, the corporation (as owner) pays the insurance premiums on a key person and designates itself as the beneficiary of the policy. This practice effectively mitigates the financial impact associated with the sudden passing of a key executive. However, when the corporation is in bankruptcy, the key person policy often has negligible value and is frequently categorized as a liability (especially given the premium payment obligations), rather than an asset. The same is often the case for other types of life insurance policies, including policies used to insure buy-sell agreements, split-dollar funded policies and personally-owned policies assigned to lenders.

As explained below, 11 U.S.C. § 363 allows the trustee or DIP to sell estate assets outside of the ordinary course of business. If the sale of policies is not possible, the trustee or DIP has three options to evaluate when administering a life insurance policy: (i) allow the policy to lapse, (ii) continue to pay the premiums to maintain the policy (assuming, of course, sufficient funds exist and the lender has consented to the use of its cash-collateral), or (iii) surrender the policy for its CSV. Unless the insured died during the bankruptcy case, a distasteful and speculative prospect for any creditor, the foregoing alternatives would never permit the estate to realize a value in excess of CSV. With Section 363, however, a trustee or DIP can expose the policies to the secondary market through court-approved auction procedures. Case studies

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suggest that well-structured 363 sales may permit the estate to realize as much as three to five hundred percent (300% to 500%) over the policy's CSV.

Legal Justification for Life Settlements

The legal and historical underpinnings of life settlements are deep. In 1899, New York's highest court held that policy owners have property rights in life insurance and, as such, can "go to the best market [they] can find, either to sell it or borrow money on it." *Steinback v. Diepenbrock*, 52 N.E. 662, 664 (N.Y. 1899). In 1911, the United States Supreme Court laid the foundation for today's life settlement marketplace, when the Court blessed and approved a policy owner's right to transfer an insurance policy. *Grigsby v. Russell*, 222 U.S. 149, 156 (1911) ("[L]ife insurance has become in our days one of the best recognized forms of investment and self-compelled saving. So far as reasonable safety permits, it is desirable to give to life policies the ordinary characteristics of property. This is recognized by the bankruptcy law . . .").

Today, 11 U.S.C. § 541 provides that a bankruptcy estate is comprised of "all legal or equitable interests of the debtor in property" "wherever located and by whomever held." 11 U.S.C. § 541(a). As the provision is liberally construed, § 541 presumptively includes conditional, future, speculative and equitable interests. See *Affiliated Computer Sys., Inc. v. Sherman (In re Kemp)*, 52 F.3d 546, 550 (5th Cir. 1995). Decisions interpreting Section 541 provide that an insurance policy is "property of the estate." See, e.g., *First Fidelity Bank v. McAteer*, 985 F.2d 114, 117 (3d Cir. 1993) ("[I]nsurance policies are property of the estate 'even though the policy has not matured, has no cash surrender value and is otherwise contingent.'") (citations omitted); *Eddy v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa. (In re Med. Asset Mgmt., Inc.)*, 249 B.R. 659, 663 (Bankr. W.D. Pa. 2000) ("An insurance policy is property of the bankruptcy estate for purposes of 11 U.S.C. § 541(a)."); see also 11 U.S.C. § 541(a)(5)(C) (providing that beneficial interests in property acquired by the debtor within 180 days after the petition date are included as property of the estate, including "as a beneficiary of a life insurance policy or of a death benefit plan"). A key person policy carried by a bankrupt corporation also becomes part of the estate under Section 541. See *Lellock v. Prudential Ins. Co. of Am. (In re Lellock)*, 811 F.2d 186, 190 (3d Cir. 1987). It therefore follows that proceeds obtained from the sale of the key person policy also is property of the bankruptcy estate. See generally *In re Insulation & Acoustical Specialties, Inc.*, 311 F. Supp. 1209 (W.D. Mo. 1969).

Trustees and debtors-in-possession owe a fiduciary duty to creditors of the bankruptcy estate, including a duty to maximize the value of the estate's assets. See 11 U.S.C. §§ 704, 1106 and 1107; see also *Official Committee of Unsecured Creditors of United Healthcare Sys., Inc. v. United Healthcare Sys. Inc. (In re United Healthcare Sys. Inc.)*, 200 F.3d 170, 177 (3d Cir. 1999); *Meyers v. Martin (In re Martin)*, 91 F.3d 389, 394 (3d Cir. 1996) ("[I]t is the trustee's duty to both the debtor and the creditor to realize

from the estate all that is possible for distribution among the creditors."). To maximize distributions to creditors, trustee's and DIPs will look to sell non-exempt assets of the estate.

To that end, and upon notice and a hearing, § 363 provides the requisite authority for a trustee or DIP to "use, sell, or lease, other than in the ordinary course of business, property of the estate." 11 U.S.C. § 363(b)(1). While courts may differ as to the requisite standard by which a debtor may sell property of the estate, it is generally accepted that a court must find either a "good business reason" or that the trustee or DIP exercised "sound business judgment" in connection with the sale of the assets. See *In re Martin*, 91 F.3d at 395; *Stephens Indus., Inc. v. McClung*, 789 F.2d 386, 390 (6th Cir. 1986) ("We adopt the Second Circuit's reasoning . . . and conclude that a bankruptcy court can authorize a sale of all a Chapter 11 debtor's assets under § 363(b) (1) when a sound business purpose dictates such action.") (citing *Committee of Equity Security Holders v. Lionel Corp. (In re Lionel Corp.)*, 722 F.2d 1063, 1070-72 (2d Cir. 1983)); *Licensing by Paulo, Inc. v. Sinatra (In re Gucci, Inc.)*, 126 F.3d 380, 387 (2d Cir. 1997); *Official Committee of Unsecured Creditors of LTV Aerospace and Defense Co. v. LTV Corp. (In re Chateaugay Corp.)*, 973 F.2d 141, 143 (2d Cir. 1992) (requiring a "good business reason"); *Committee of Asbestos-Related Litigants and/or Creditors v. Johns-Manville Corp. (In re Johns-Manville Corp.)*, 60 B.R. 612, 616 (Bankr. S.D.N.Y. 1986) ("Where the Debtor articulates a reasonable basis for its business decisions (as distinct from a decision made arbitrarily or capriciously), courts will generally not entertain objections to the Debtor's conduct.").

Consequently, where the possibility exists that a debtor's estate may possess an interest in a life-insurance policy, the statutorily imposed duties require that a trustee or DIP devote sufficient attention to the policy to maximize its value for creditors. Section 363 affords an expedient means of doing so through life settlements.

Mechanics of a Life Settlement

A life settlement is the sale of an existing life insurance policy to institutional investors. Typically (although not exclusively), the likely buyers of policies of this type are commercial and investment banks, pension and hedge funds and insurance companies. These investors underwrite the policies' fair market value and purchase them from the policy owner for a one time lump-sum payment. Upon the settlement, the purchaser then assumes title and responsibility for all future premium payments.

Life settlements are available for all varieties of life insurance, including universal life, variable universal life and convertible term policies. Term policies—which debtors rarely even ever disclose on their schedules or statement of financial affairs—can be the most valuable of all policies and provide windfalls to creditors. Because term policies do not carry a CSV, the policies are often cancelled, ignored or otherwise permitted to lapse for non-payment in the weeks leading up to a bankruptcy filing. Critically, however, most term policies contain a conversion feature, providing the owner with the right to convert from a term

policy to a permanent policy. In a pre-arranged § 363 sale, the policy owner can exercise this conversion right, and thereafter the parties can consummate a life settlement, thereby extracting value from an otherwise worthless asset.

Generally, life settlements make economic sense only if the insured is over sixty-five (65) and maintains at least \$250,000 of life insurance coverage. To be considered a life settlement candidate where the insured is younger than 65, the insured would have to possess significant medical impairments. Many factors influence the fair market value of a particular policy, including the insured's age, gender, health, as well as the size, CSV and type of policy.

Compared with the sale of most assets under § 363, the procedures for selling a life settlement are simple, especially with the assistance of a professional broker. Upon retention of a broker (typically on a contingent fee basis under 11 U.S.C. § 328(a)), an application is signed, medical information is collected, life expectancy reports and policy information are gathered, and information is packaged to a targeted market of potential bidders. The broker can also perform a comprehensive analysis to determine the relative value of a policy and conduct an auction where bids are presented to the trustee or DIP for acceptance.

While the procedures may be simple, the dynamics of closing a life settlement are nuanced to necessarily require particularized expertise, and even the most skilled trustee or DIP would benefit from retaining a life settlement broker. A broker can perform all of the necessary services to the trustee or DIP to close a 363 sale quickly and maximize recoveries, while navigating the challenges of today's settlement market and the healthcare industry. Some of these services may include advising the debtor with respect to all issues concerning the marketing and sale of a single policy or portfolio of policies; assisting the debtor in complying with relevant privacy laws and regulations, including the Health Insurance Portability and Accountability Act of 1996 ("HIPAA"); communicating with the issuers of the policies and others to obtain necessary information to market and sell the policies, including the transfer of ownership to the successful purchaser; collecting health information on the insureds and various premium illustration scenarios from the carriers to develop a valuation report; marketing the policies to targeted buyers; educating potential buyers about the debtor's bankruptcy case and related sale process; assisting with appropriate bidding procedures; assisting the debtor with negotiating the terms of the sale and coordinating the sale process and otherwise assisting the debtor in obtaining court approval of any sale, including by providing testimony in support of such sale.

Examples of Bankruptcy Cases Where Life Settlements Have Been Sold Pursuant to Section 363 and Used to Monetize Insurance Assets:

- *In re Gary Wilder and Toni Jo Wilder*, No. 09-bk-71141 (Bankr. C.D. Ill. Apr. 17, 2009) ("*Wilder*").

In *Wilder*, the Chapter 7 Trustee, Mariann Pogge, administered a bankruptcy case where the scheduled assets were \$8,600,000 (consisting of approximately \$8,400,000 of real property) and the scheduled liabilities exceeded \$260,000,000 (thus, providing little hope for any meaningful recovery to creditors). Notably, among the estate assets were three life insurance policies, each having zero CSV, but with \$44,000,000 in aggregate death benefits. The Trustee and several interested creditors attempted to market the three policies, however, despite their best efforts, the highest bid received was \$250,000 (\$50,000 cash plus forgiveness of an existing \$200,000 administrative claim) from a group of creditors. Having never administered life insurance policy assets in an admittedly "challenging" case, the Trustee hired a broker to market and sell the policies. Within two and half weeks after the bankruptcy court approved retention of the broker, the Trustee filed motions to sell the policies for an amount over twenty times greater than the previous \$250,000 offer. While this bid, if approved, would have resulted in a successful sale for the creditors of the estate, the broker and the Trustee continued to market the policies, and received and evaluated bids up to the scheduled sale hearing. Ultimately, the bankruptcy court approved the sale to the highest bidder—a winning bid of \$8,900,000 (or over thirty-five times greater than the initial \$250,000 creditor offer) and a sale that closed within two months.

- *In re Ronco Corporation, et. al.*, No. 07-bk-12000 (Bankr. C.D. Cal. June 14, 2007) ("*Ronco*").

In *Ronco*, the estate's "assets" included one term policy that was on the verge of lapsing. The policy had a zero CSV and a death benefit of \$15,000,000. Upon conversion to Chapter 7, the Trustee retained a broker to evaluate a potential sale. With the broker's assistance, the term policy was converted to a universal life policy and, thereafter, extensively marketed and sold, resulting in a winning bid of approximately \$3,500,000. Critically, the sale yielded sufficient funds to pay off the debtor's senior secured lender, in full.

A Buyer's Prospective

The role, and perhaps principal responsibility, of a life settlement provider is to conduct rigorous due diligence, compliance and underwriting of each policy offered for sale. As is the case in any asset purchase, proper valuation, efficiency and predictability of closing and passage of clean title are the key components.

The auction process is straightforward, transparent and largely devoid of the idiosyncrasies which frequently bedevil purchases from individual policy sellers. The process is conducted within a clear and concise set of rules and regulations.

Ultimate valuation (i.e. acquisition price) is efficiently determined and transparent as well. Your bid either wins or not by the established deadline.

Given the absence of title insurance in life settlements, a purchase out of § 363 provides the buyer with virtually unchallengeable title to the asset.

Conclusion

Life settlement markets have only recently begun to develop out of infancy, and are generating an increased focus in bankruptcy cases. Where the possibility for insurance-policy assets exist, trustees or DIPs should not arbitrarily surrender the policies for the CSV or permit the policies to lapse without an appraisal of their true market value, even in the most contentious of cases with hostile lenders objecting to the use of cash collateral. Rather, practitioners should consult an experienced life settlement broker to evaluate the policies, and consider an organized Section 363 sale to maximize recovery for the estate and its creditors. Even in situations where a policy has CSV, a life settlement should be considered as it often provides significant cash recoveries far in excess of CSV, thus generating revenues at precisely the right time.

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