



Life Insurance Settlements: A Potentially Powerful Cash Generation Tool

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Today's turbulent economic climate requires that bankruptcy trustees proactively manage the assets in the estates they are administering in order to maximize their value. Consequently, bankruptcy trustees are looking for new and creative ways to liquidate estate assets in order to achieve this goal. Although historically overlooked, one class of estate assets—life insurance policies—can be monetized, resulting in a meaningful financial distribution to the trustee. In recent years, bankruptcy trustees have successfully sold, at values higher than the policy's cash surrender value, the Debtor's right, title and interest in policies owned by the Debtor, regardless of whether the insured is the Debtor, employed by the Debtor or an unrelated third person. Bankruptcy trustees should ensure that these frequently overlooked assets are successfully administered as valuable and saleable assets.

Corporate owned life insurance policies, also known as “key person” policies, have traditionally been viewed as a “contingent asset,” meaning the policy has no value until the key person dies. Typically, the business (as owner of the policy) pays the insurance premiums on a key person and designates the corporation as the beneficiary of the policy. Although this can be a highly effective means of offsetting the financing impact associated with the sudden passing of a key executive, the policy often has little or no value to a company going through liquidation or reorganization. Moreover, due to the obligation to pay premiums, policies of this type are often viewed as a liability as opposed to an asset.

Until recently, there were three options for the Trustee: (i) allow the policy to lapse; (ii) continue to pay the premiums (assuming there were funds and the secured lender consented to such disbursements) to keep the policy in place; or (iii) surrender the policy for the cash surrender value, or CSV. Now, however, trustees have another alternative: selling the policy to the highest bidder, for cash, in an auction sale approved by the Bankruptcy Court.

Empirical evidence suggests that selling these policies in the secondary market allows the trustee to realize three to five times the cash surrender value of the policy.

Mechanics of a Life Settlement

A life settlement is the sale of an existing life insurance policy from the current owner (the company, if it is a key person policy) to institutional investors, such as commercial and investment banks, pension and hedge funds and insurance companies. These investors assess the fair market value of these policies and purchase them for a one time lump-sum payment to the policy owner and then assume responsibility for all future insurance premium payments.

All policies, including universal life, variable universal life and even convertible term policies are eligible for a life settlement. In fact, term policies, which often are not included on a Debtor's Schedules and Statement of Financial Affairs, can prove to be the most valuable of these hidden assets. Due to the fact there is no cash surrender value, they are often cancelled or even worse, allowed to

lapse for non-payment in the weeks leading up to a bankruptcy filing. However, the vast majority of term policies contain a conversion feature, providing the owner with the right to convert from a term policy to a permanent policy. Upon exercise of the conversion right, a debtor can then consummate a life settlement and extract value from an otherwise worthless asset.

To qualify for the life settlement option, the general rule of thumb is the insured must be over 65 years of age, with at least \$250,000 of life insurance coverage. There are many factors, including age, gender, health of the insured, and the size and type of the policy that influence the ultimate purchase price of the policy. The life settlement process is relatively simple; it's strictly paperwork. An application is signed, medical information is collected, life expectancy reports and policy information are gathered, and these items are set out to the market. At that point, a life settlement broker can perform a comprehensive analysis to determine the relative value of a policy and then conduct an auction-like process in which bids are presented to the broker for acceptance, a process that should be handled on a contingent basis.

Legal Justification for Liquidating a Policy

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 (1899)). The Supreme Court laid the groundwork for today's life settlement marketplace in 1911, when it established the policy owner's right to transfer an insurance policy (*Grigsby v. Russell*, 222 U.S. 149 (1911))

As it relates to bankruptcy, once a petition is filed, an estate is created pursuant to section 541, of title 11, United States Code, section 101 et seq. (the "Bankruptcy Code"). The 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). This concept includes conditional, future, speculative and equitable interests. See *Kemp v. Affiliated Computer Sys., Inc.*, 52 F.3d 546, 550 (5th Cir. 1995). As such, an insurance policy is "property of the estate." See, e.g., *First Fidelity Bank v. McAteer*, 985 F.2d 114 (3d Cir. 1993); *Med. Asset Mgmt., Inc. v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa.*, 249 B.R. 659 (W.D. Pa. 2000) ("An insurance policy is property of the bankruptcy estate for purposes of 11 U.S.C. § 541(a)"). A life insurance policy carried by the bankrupt corporation upon the life of an officer or large stockholder, at the expense of the corporation, passes to the trustee as an asset of the estate. *Estate of Lellock v. Prudential Ins. Co. of Am.*, 811 F.2d 186, 190 (3d Cir. 1987). Therefore, proceeds obtained from the sale of the life insurance policy become property of the corporate debtor's bankruptcy estate. See generally, *In the Matter of Insulation & Acoustical Specialties, Inc.*, 311 F.Supp. 1209 (W.D. Mo. 1969).

Bankruptcy trustees and debtors-in-possession owe a fiduciary duty to creditors of the bankruptcy estate, which includes a duty to maximize the value of the estate's assets. See 11 U.S.C. §§ 704, 1106 and 1107; see also *In re United Healthcare Sys. Inc.*, 200 F.3d 170 (3d Cir. 1999) cert. denied, 530 U.S. 1204; *Meyers v. Martin*, 91 F.3d 389, 394 (3d Cir. 1996). In order to maximize values, Trustees liquidate non-exempt assets of the estate.

Upon notice to parties in interest and a hearing by the bankruptcy court, a debtor-in-possession or trustee "may use, sell, or lease, other than in the ordinary course of business, property of the estate." 11 U.S.C. § 363(b)(1). While bankruptcy courts may differ as to the standards by which a debtor may sell "property of the estate," it is generally accepted that the court must find, from the evidence, a

"good business reason" or, that the Trustee exercised "sound business judgment" in connection with the sale of the assets. *In re Martin*, 91 F.3d 389 (3d Cir. 1996), citing, *In re Schipper*, 933 F.2d 513 (7th Cir. 1991); *Stephens Indus., Inc. v. McClung*, 789 F.2d 386 (6th Cir. 1986); *In re Lionel Corp.*, 722 F.2d 1063 (2d Cir. 1983); *In re Gucci, Inc.*, 126 F.3d 380, 387 (2d Cir. 1997); *In re Chateaugay Corp.*, 973 F.2d 141, 143 (2d Cir. 1992); *In re Johns-Marville 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.").

Examples of bankruptcy cases where life settlements have been used to monetize insurance assets include:

In re Wilder, Case No. 09-71141, United States Bankruptcy Court for the Central District of Illinois, Springfield Division.

The Chapter 7 trustee administered a case with minimal assets and in excess of \$200 million in claims. Among the estate assets were three life insurance policies having an aggregate death benefit of approximately \$44 million, yet having virtually no cash surrender value. The trustee's initial efforts at selling these policies generated a \$250,000 bid (\$50,000 cash plus forgiveness of an existing \$200,000 administrative claim) from a group of creditors. Having never encountered life insurance policy assets in an admittedly "challenging" case, the trustee hired the writer's company to market and sell the policies. Within 2 ½ weeks after entry of the employment order, the trustee filed motions to sell the three policies for an amount in excess of twenty times greater than the previous bid. While this result would have resulted in a successful sale, additional bids were received up to the Court's decision to grant the sale Motion. The net result – a winning bid of \$8.9 million and a sale that closed within two months.

In re Ronco Corporation, et. al., Case No. 07-12000 (GM), United States Bankruptcy Court for the Central District of California, San Fernando Division.. In *Ronco*, term policy was converted to a universal life policy and thereafter marketed and sold. The resulting sale proceeds of approximately \$2.7 million were delivered to the Trustee.

Conclusion

In scenarios in which insurance assets exist, the policy should not be arbitrarily surrendered for the cash surrender value or allowed to lapse without an appraisal of its true market value. A trustee should consult an experienced life settlement broker, who has significant bankruptcy experience to assess the true fair market value of such policies and thus obtain the highest monetary value of those assets. Even in situations where the policy has cash surrender value which might be immediately realized, a life settlement should nevertheless be considered as an alternative as it often provides a greater return than simply liquidating the cash surrender value.

Editor's note - the NABT does not endorse any particular company with respect to the sale or marketing of life settlement contracts. 🏠



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