MONEY FOR YOUR LIFE (INSURANCE)

Selling a policy for cash is not as unusual as you might think.

BY HEATHER MORTON

Sally, who suffers from breast cancer, decided to sell her life insurance policy to investors to pay for her growing medical expenses. She got $250,000 for it, which she used to buy medicine. The investors will receive her $500,000 death benefit when she dies.

Many people might be surprised to learn that a life insurance policy is an asset that can be sold. But such transactions can be arranged through a broker who works on behalf of the policyholder and solicits multiple bids, or a provider that represents a single firm interested in purchasing the policy. The investors are typically hedge funds and financial institutions.

There are restrictions on such transactions. For example, a person can legally sell a policy to a third party for more than the "cash surrender" value, the dollar amount set by the insurance company if the policy is voluntarily terminated before it matures. But it must sell for less than the policy's death benefit.

Such a sale is called a life or viatical settlement, which goes back to a Latin term that refers to providing a stipend or living expense. For more than 130 years, the U.S. Supreme Court has held that a life insurance policy is an asset that, acquired for valid reasons, can be sold to a third party. The viatical settlement business developed in the 1980s and 1990s as AIDS patients and other terminally ill patients sold their life insurance policies as a way to pay for their health care.

Heather Morton covers insurance issues for NCSL.

As advances in medicine increased the life expectancy for people with AIDS, the market changed its focus to senior citizens who no longer needed their life insurance policies. As the emphasis changed, the terminology changed from viatical settlements to life settlements.

"Consumers are, in these difficult times, frequently faced with significant challenges in planning," says Doug Head, executive director of the Life Insurance Settlement Association. "Perhaps they have been oversold on insurance or had expectations of greater assets than now seem realistic. A life settlement is both logical and appropriate for some consumers."

STATE ATTENTION

The increase in people buying life insurance policies specifically to sell to others, however, is what has garnered the attention of state legislators and insurance regulators. The life settlements industry has grown from $2 billion in 2001 to $16 billion in 2008. When a person applies for life insurance and has already agreed to sell the policy to someone else in the future, it is known as stranger-originated life insurance or speculator-initiated life insurance.

Here's an example. Joe is approached by an investment company to purchase a $1 million life insurance policy if he will turn the policy over to the investment company after two years. In exchange for the policy, the investment company will pay the premiums and give Joe a lump-sum payment when he turns over the policy.

"It is a shady practice for a third party stranger, who has no insurable interest, to solicit an individual to purchase a life insurance policy; then to finance or pay for the premiums, become the owner and hope the individual dies, all for the purpose of making a buck," says Michael Ripley, a six-term member of the Indiana House who served on the Insurance Committee. He retired in 2008.

Proponents say life settlements and stranger-originated life insurance give people facing financial hardship an opportunity to sell their insurance policies if the premium payments no longer are affordable.

Candidates for life settlements and stranger-originated life insurance are typically 65 or older. Factors used to determine a policy's price include the market value, the cost of premiums and the life expectancy of the insured. Generally, the lower the premium and life expectancy of the insured, the higher the market value.

In a stranger-originated life insurance transaction, the investor loans the insured money to pay the policy's premiums. After a specified amount of time—usually the two-year period during which the insurance company can legally challenge the validity of the policy—the insured transfers the policy to the investor to pay off the loan. In some cases, the insured may receive a cash payment after settling the loan. The third-party investor owns the policy and receives the policy's death benefits when the insured dies.

Critics of this practice says it increases life insurance costs, can make it difficult for people to buy other life insurance because they may be deemed "over insured," or may cause unexpected tax liabilities for the insured.

"The value of human life essentially is reduced to a commodity that is auctioned off in the futures market to the highest bidder," says Frank Keating, president and CEO of the American Council of Life Insurers. "That's not what life insurance is all about."

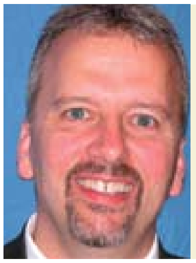
Opponents argue stranger-originated life insurance circumvents state laws that require the beneficiary of a policy to have an interest in the life rather than the death of the insured. Critics also raise questions about investors who loan the insured money for the cost of the premiums. The loan to cover the premiums may be more than the agreed upon cash payment, and the insured may end up owing the investor money after transferring the policy. Stranger-originated life insurance also can lead to misrepresentation in the application for the life insurance policy.

In January 2008, a federal judge for the Northern District of Georgia ruled in favor of an insurance company that had issued an insurance policy in a stranger-originated transaction. An 82-year-old man—solicited by investors—applied for a life insurance policy, claiming a net worth of more than $10 million and an annual income of more than $150,000. American General Life Insurance insured him for $7 million. When he died in less than a year, an investigation found the man had misrepresented his net worth and income; he actually had a net worth of $160,000 and annual income of $7,200.

STRICTER REGULATION

In 2008, lawmakers in at least 20 states introduced legislation regulating and restricting life settlements and stranger-originated life insurance. Arizona, Connecticut, Hawaii, Indiana, Iowa, Kansas, Kentucky, Maine, Nebraska, Ohio, Oklahoma and West Virginia passed legislation. Generally, the laws extend the time before a person can sell the insurance policy, identify and deter stranger-originated life insurance transactions before the policy is issued, or a combination of the two.

Ohio lawmakers increased the waiting period to sell life insurance policies originated and funded by investors from two years to five. Life insurance companies must now ask specific questions to identify stranger-originated life insurance transactions and report them to the Ohio Department of Insurance. The department has additional oversight authority over life settlement brokers and life settlement providers.



REPRESENTATIVE
JOHN BRAUTIGAM
MAINE

Arizona's law prohibits intentionally initiating a life insurance policy for a person or entity without an insurable interest in his or her life at the time of the policy's origination. West Virginia's new law defines issuing, soliciting, marketing or promoting stranger-originated life insurance as a fraudulent viatical settlement act.

"When a stranger owns someone else's life insurance policy, a moral hazard arises," says Maine Representative John Brautigam, House chair of the Insurance and Financial Services Committee. "Life insurance is primarily intended to protect one's family or business associates in the event of death and to give peace of mind to the insured. I am concerned that this important function could be compromised by this new trend of investing in the death of other people."