

DUE DILIGENCE IN THE LIFE SETTLEMENT MARKETPLACE

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< Slide Pg 1 >

Good afternoon.

I'd like to thank everyone for attending this session of the National Underwriting Conference; I'm David Binter, the President of Neuma.

The subject of this talk is Due Diligence in the Life Settlement Marketplace.

As a CPA, a trader on the floor of the Chicago Board Options Exchange, the managing partner of a stock options trading firm, a founding member of LISA, and the president of Neuma, my career has focused on due diligence issues.

Everyone says: "Open with a joke", so here goes:

A fellow had just been hired as the new CEO of a large corporation. The retiring CEO met with him privately and presented him with three numbered envelopes. "Open one of these envelopes if you run into a problem that you can't resolve," he said.

Things went along pretty smoothly, but six months later, business took a downturn. At his wit's end, the CEO remembered the envelopes. He went to his desk drawer and took out the first envelope. The message read, "Blame your predecessor."

The CEO called a press conference and tactfully laid the blame at the feet of his predecessor. Satisfied with his comments, the press and Wall Street responded positively. Sales began to pick up and the problem was soon forgotten.

About a year later, the company again experienced a dip in business. Having learned from his previous experience, the CEO quickly opened the second envelope. The message read, "Reorganize."

He did so, and the company quickly rebounded.

After several consecutive profitable quarters, the company once again fell on difficult times. The CEO went to his office, closed the door and opened the third envelope. The message said, "Prepare three envelopes."

Today, you can't resolve crises by merely blaming your predecessor or instituting a reorganization plan.

By adhering to these due diligence pointers, you will, hopefully, never have to open your three envelopes.

< *Slide Pg 2* >

Due diligence risk can be broken down into two separate and distinct areas: document risk and transactional risk.

< *Slide Pg 3* >

The first type of risk – and the one with which we are most familiar – is document risk. Questions for you to ask are:

- Are my licenses current and in order?
- Has a review of the state's laws and regulations been undertaken to ensure that no changes have recently occurred?
- Do my documents meet the requirements of the state in which the policy is being transacted?
- Are my documents appropriate for the following situations and transactions: a whole life policy; a variable policy, which requires proper broker/dealer licensing; a trust; a corporation; an LLC or partnership; a divorce; or a bankruptcy?

< *Slide Pg 4* >

A second and more elusive type of risk relates to the nature of the life settlement transaction itself:

- Is the policy transfer legal, and does it conform to the documentation which the seller has provided?
- Is the seller properly authorized to transact the sale of the policy?
- If the policy is corporate-owned, is the seller authorized to transfer ownership?
- If the policy is owned by a trust, is the trustee authorized to transfer ownership?
- Has a proper trust or Irrevocable Life Insurance Trust (“ILIT”) been established?
- If the policy had previously transferred ownership, is there a clearly-documented chain of title?

< *Slide Pg 5* >

- Was insurable interest present at the time the policy was originated?
- Was the policy premium-financed? And, if so, was the financing recourse or non-recourse?
- And lastly, have the seller and all other parties to the transaction been vetted to limit the possibility of money laundering? At a minimum, all names should be checked against the US Department of the Treasury’s OFAC list.

The US Department of the Treasury’s Office of Foreign Assets Control (“OFAC”) administers and enforces economic and trade sanctions based on US foreign policy and national security objectives. Both domestic and foreign individuals and entities may be prohibited business partners. If so, their names will appear on the OFAC list.

If you find a match, you must exercise extreme caution and notify the appropriate authorities. Be aware that even unwitting participation in a money laundering scheme can be considered a violation of US law.

< Slide Pg 6 >

Managing Risk:

Obviously, in states where regulation exists or is pending, each contract document should – at a minimum – meet state requirements. If specific forms approval is required, all documents must be approved prior to use.

Once signed contracts are returned to you by the policy seller and the insured, you must check the signatures for consistency and make sure that all documents are properly notarized and dated. Names, Social Security Numbers, Tax ID Numbers, addresses and other pertinent information must match in all records. If there is any mismatch, it must be resolved.

Supporting documents such as life insurance applications, medical records, trust agreements, corporate authorizations, and bankruptcy or divorce documents must be similarly vetted to ensure that statements are consistent. The potential for problems with supporting document is unlimited; and the consequences of poor documentation include purchasing a worthless investment.

< Slide Pg 7 >

For life insurance applications, ask:

- Are answers in the life insurance application consistent with those in the life settlement application?
- Does the insured's and policy owner's financial information provided in the life insurance application conform to that in the life settlement application?
- Does the insured's health, as described on the life insurance application, conform to the life settlement application and the medical records?

< Slide Pg 8 >

For medical records, ask:

- Do the medical records appear to be complete and current? At Neuma, we utilize an independent medical professional to evaluate these records to “red flag” any inconsistencies or deficiencies.
- Is data in the medical records consistent with data in the life insurance application and the life settlement application?

< Slide Pg 9 >

For trust-owned policies, ask:

- Has a complete copy of the trust document been provided, and not merely a redacted copy? A detailed reading of the document may lead to the discovery of provisions adversely affecting the transaction.
- Was the trust in existence when the policy was issued?
- Has the trust remained in effect since its creation?
- Where is the trust domiciled? The failure to have a trust properly domiciled could result in a death claim by a life settlement provider being voided.
- Has the trust always been domiciled in this state?
- Is the state of the trust’s domicile identical to the state of the policy’s previous owner(s) or beneficiaries?

< Slide Pg 10 >

- Is the trust empowered to sell the policy to a third party?
- Is the trustee properly appointed?
- If the trustee is a successor trustee, is he or she authorized to dispose of this asset?
- Are all trust document properly signed and notarized?
- If the policy was transferred from a previous owner to the trust, is there a correct grant of the policy to the trust?

< Slide Pg 11 >

For corporate-owned policies, ask:

- Is the corporation in Good Standing with the state?

- Are pertinent corporate documents included?
- Are Articles of Incorporation provided?
- Are the Corporate By-Laws included?
- Is there a Corporate Resolution by the Board of Directors authorizing the policy's sale?
- If the corporation is the original owner and beneficiary of the policy, is there a statement of insurable interest?

< Slide Pg 12 >

- Is this a “janitor policy” or a true executive officer policy that was obtained for reasonable corporate purposes? In 2006, a federal court in Oklahoma approved a settlement with Wal-Mart and certain employees involving Corporate Owned Life Insurance (“COLI”) policies – the so-called “janitor policies.” The effect of this settlement means that such policies could be worthless for subsequent policy owners.
- Are any lawsuits pending against the corporation? If the policy is being sold by a corporation in liquidation, due consideration should be given to the possibility that the seller's bankruptcy could result in legal action and ultimately the policy's rescission.

< Slide Pg 13 >

If there is a bankruptcy after the policy's issue, ask:

- If the policy was transacted through a bankruptcy court, is there clear title free of creditors' liens? The Bankruptcy Court must issue an order to this effect, signed by the judge and properly entered in order to establish clean title.
- Are all discharge papers in order?
- Is the policy unencumbered?

< Slide Pg 14 >

For divorce, ask:

- Can this policy be sold? The policy might be held jointly, or there may be an agreement that certain assets be retained until a child reaches a specified age.
- Are all divorce documents included?
- Is the divorce decree executed and properly issued by the Court?

< Slide Pg 15 >

The ultimate price for not exercising extreme caution in the due diligence process is loss of the investment. Documents often cannot be recreated and signed years later. Documents with missing pages may not be able to be reconstructed. Trustees, corporate owners, sellers or insureds may no longer be available to correct deficiencies. You must get it right before the policy transfers and before funds leave the escrow account.

If you do not get it right, the insurance company has no incentive to grant you any leniency. It is in the carrier's interest to let claims linger, with funds remaining in its possession. Your last resort may be legal action with an uncertain outcome and ever-increasing expenditures.

While continued requests for additional documentation do not endear us to brokers, they must understand that a policy cannot be purchased until all documentation is complete and thorough. If any requirements are not met, the policy will simply not close.

< Slide Pg 16 >

Premium Financing:

Premium financing presents a new area of risk. Premium financing was originally created to enable policy owners to overcome temporary cash flow shortfalls. For example, a manufacturer of Christmas toys would be cash rich in January after his retail customers paid him; but by midyear, he would be building inventory and would be cash poor. He might now require financing to pay for his life insurance premiums.

In the past few years premium financing programs have evolved. There are now programs for Stranger-Owned Life Insurance (“STOLI”) policies and COLI policies. With these programs, the issue of “insurable interest” has come to the fore.

< *Slide Pg 17* >

Questions for you to ask are:

- Was there an insurable interest when the policy was issued? If it was not present at the policy’s inception, it can never be reconstituted.
- If the insured paid the first premium and immediately resold the policy; can the carrier then claim that since the original intent was to resell the policy, the policy can be voided?
- Was the policy financed by recourse or non-recourse premium financing?
- What are the details of the financing program?

As I speak, there are several cases being litigated in which insurance companies are seeking to invalidate policies by alleging that no legitimate insurable interest was present at the policy’s inception. Regardless of who wins, I am sure you are aware that litigation is an expensive and risky proposition.

One of the most interesting of these recent cases is Life Product Clearing LLC v. Angel, decided this January by the Southern District Court in New York. In this declaratory action case, an investor sued the insured’s daughter, who served as the estate’s personal representative. Basically, the daughter, the trustee of a trust and the investor agreed on the facts (i.e., “stipulated”) and sought the Court’s decision as to who should be entitled to receive the deceased father’s (Leon Lobel’s) \$10 million face value life insurance policy.

The facts involved a deal we are all doubtless familiar with, in which an individual receives an immediate cash payment (in this case, \$300,000) in exchange for signing up for a large face value life insurance policy (in this case, \$10 million).

While this case is very important for the ongoing discussion over

stranger-originated life insurance policies, what is equally important for my discussion today is a list of the facts that the Court relied upon. These facts relate directly to your due diligence. Finding one or more of these facts, or failing to find one or more of these facts, could be crucial in determining whether a policy could turn into a good or bad investment down the road. As we all know, uncertainty is one of the worst things in the investment world. Failing to find one of these facts could substantially add to an investment's uncertainty as well as its cost.

< Slide Pg 18 >

Among the facts that the court relied upon, I will highlight those that relate to the documents, and therefore could possibly have been uncovered prior to purchasing such a policy:

- Lobel, the insured, could not afford to pay the extremely high premiums on the Policy – the Court noted that Lobel made a statement to the insurance company that he had a net worth of \$8 -10 million (and presumably could pay the Policy premiums). In truth, he had lied on his application;
- Lobel executed the Trust Agreement the same day he applied for the Policy;
- The Trust Agreement mentioned the investor by name as the possible future transferee;
- The Court noted that the investor's counsel prepared the Trust Agreement, and therefore was involved from the outset;
- There was no indication that Lobel provided any input into the drafting of the documents;
- The insurance agent's letter was dated just two days after the Policy was issued. Also, this letter noted Lobel's interest in assignment and enclosed two forms that already named the investor as the transferee;
- The dates of signature indicated that Lobel signed the

documents immediately upon receipt, and so apparently did not take any time to consider other options or the details of the investor's offer;

- Lobel assigned his interest in the Trust just a few days after the Policy was issued; he was the beneficiary of the Policy for at most a few days; and he never paid any premiums on the Policy;
- Lobel was not even given a copy of the Policy; and
- When Lobel applied for the Policy, his agents did not answer the question in the application form asking whether the client was purchasing the insurance for "any type of viatical settlement, senior settlement, life settlement or for any other secondary market."

What is important in this case is how the Court focused on the complete picture of the transaction. In this case the Court came to the conclusion that the documents and other facts "make a plausible claim that Lobel intended to transfer the Policy to ... [the investor] ... prior to procuring it." Coming to this conclusion, the Court characterized this as a "scheme" which was an "impermissible attempt to circumvent the prohibition on wager policies."

The Court decided, based on these facts and documents that the investor could not prevail at this stage. The investor now must decide whether to go to a trial or settle the case for less than it planned on receiving, \$10 million in face value plus interest at this point.

< *Slide Pg 19* >

Due diligence requires us to resolve any and all issues of insurable interest prior to purchasing a policy. Particular attention should be paid to such states as New York and Illinois that have implemented STOLI guidelines or have issued STOLI warnings. And legislation targeting STOLI is now moving through several state legislatures.

< *Slide Pg 20* >

As a final thought, I would quote my ex-partner when we owned a securities trading firm, "Opportunity lost beats the hell out of money lost."