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Hedge Fund Investments in Life Insurance Policies

Is the Life Settlement Market a Safe Bet?

By R. Mark Keenan and Craig M. Hirsch

Hunting for the next investment horizon, private equity and hedge funds have entered into the life insurance market with a full head of steam. State regulators have struggled to keep pace with this investment rush. By 2007, an estimated $15 billion to $18 billion could be riding on life insurance policies controlled by private investor groups.

However, when the regulators do catch up (and they will), the courts could turn billions of dollars into zero dollars in the blink of a judicial eye. The New York attorney general is investigating the accounting of such arrangements. Private equity and hedge funds need to seek counsel to determine their potential liabilities before betting the house on the secondary life insurance or life settlement market.

Free Term Life Insurance: How Does it Work?

Essentially, life settlement companies purchase life insurance policies from senior citizens at a price higher than the policy's cash value, but lower than the insurance proceeds paid out when the policyholder dies. Initially mere purchasers of settlement contracts, investors behind private equity and hedge funds have taken it further, now advancing capital at the front end to initiate these transactions. And the ideal policyholder is always targeted — a life expectancy of six to eight years accompanying an impaired health status.

As we speak, private equity and hedge funds are becoming premium lenders to individuals seeking life insurance coverage using these "investor initiated life insurance," "nonrecourse premium financing," "secondary life insurance" or life settlement transactions.

Stripped down, these transactions are quite simple. A hedge fund reaches out to an individual, typically over 70, and offers to buy them free life insurance for a period of at least two years, the premiums supplied as a loan with accruing interest. Typically, life insurance policies cannot be contested by the insurance company after two years. Thus, material misrepresentations made by the policyholder in the insurance application will no longer be grounds to vitiate the policy.

After two years, the policyholder typically has two options: (1) satisfy the loan plus interest in order to maintain ownership of the policy or (2) assign the policy and all rights to coverage to the hedge fund lender. In some instances a third option may be to sell the policy to a third party and use the sale proceeds to satisfy the debt owed to the hedge fund. This is a "no risk" proposition for the policyholder who pays nothing during the first two years. If the policyholder dies within the two-year window, the insured's beneficiary will collect the proceeds less the outstanding loan balance and interest.

On the other hand, if our policyholder survives the two years, he or she faces this choice: pay the loan with interest or relinquish the collateral — the life insurance policy and its future proceeds — to the hedge fund.

The hedge funds have put themselves in an auspicious position — either as the likely recipient of the policy's proceeds when the insured dies or as a fully satisfied lender, recouping both principal and interest on its loan of premiums.

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Presented with a win-win situation, investment funds have flocked to the secondary life insurance market.

As hedge funds move in great haste to position themselves in this market and maximize their returns, initial concerns have cropped up making the initial rush bittersweet. Giving an individual a two-year free ride — life insurance coverage purchased at no cost — may create moral hazards or promote fraud. However macabre the concept, a gravely sick or disabled individual may attempt to end their life prematurely understanding that his or her coverage is cost-free for only two years. With such an unseemly result, many critics are quick to point out that hedge funds do not have an "insurable interest" in the life insurance policy beyond a financial one.

The time-honored insurance law concept of insurable interest is to require those who buy life insurance to have an insurable interest — a family relationship or strong financial interest (i.e., "keyman" life insurance) — in the insurance policy in order to prevent people from gambling on the lives of strangers.

The New York Superintendent of Insurance Weighs In

The New York attorney general has issued his first wave of subpoenas seeking accounting and financial reporting information in connection with life settlement transactions. Critics speculate that using the insurance policy as collateral for the loan that financed its purchase may run afoul of many jurisdictions' insurance laws and regulations. Most recently, a hypothetical life insurance transaction of this variety drew the ire of the State of New York Insurance Department. On December 19, 2005, the Insurance Department issued an advisory opinion determining that these premium financing agreements violate New York Insurance Law § 3205(b).

The crux of the opinion focused on the absence of a "legitimate insurable interest" on the part of the hedge fund lender in the life of the policyholder. According to the Insurance Department, the party causing procurement of the life insurance — i.e., the hedge fund — must have either a "substantial interest engendered by love and affection" or "a lawful and substantial economic interest in the continued life" of the policyholder pursuant to Section 3205(a)(1). A mere financial interest in the policy's proceeds was not enough.

Conclusion

In this uncertain legal climate, legal review and analysis of these relationships are required. Is your loan — your economic interest in the life insurance policy — enough to withstand regulatory muster? The regulatory response to this investment craze is in its nascent stages. However, the wild west days of the life insurance market could be numbered. If the courts, taking their cue from state regulators, render these transactions illegal, billions of dollars could transform into zero dollars in a heartbeat. Thus, private equity and hedge funds should take a pausing breath and seek counsel to determine their potential liability versus potential revenue when piling up dormant life insurance policies.

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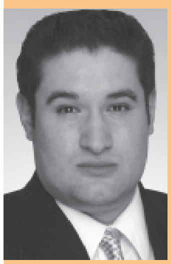

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The article appearing in this alert does not constitute legal advice or opinion. If you require more information, legal advice or an opinion with respect to a specific situation, please contact the group chairs, R. Mark Keenan, chair, at (212) 278-1888 or mkeenan@andersonkill.com or David M. Schlecker, co-chair, at (212) 278-1730 or dschlecker@