## Life Settlements Due Diligence: Legal Counsel's Perspective

In addition to the important diligence issues associated with the pricing and valuation of life settlements, life settlements have characteristics that make thorough legal due diligence particularly important. Unlike stocks or bonds, there are no widely accepted exchanges across which life settlements trade, nor are there regulatory agencies, such as the Securities Exchange Commission, that mandate standardized disclosures to investors in the asset class. Hence, transactions tend to occur on a one-off basis, and are frequently subject to information asymmetry between the seller and the purchaser, heightening the need for robust due diligence.

Some of the issues associated with life settlements that require diligence include certification of title to the asset; regulatory compliance with origination of the asset; and insurable interest issues.

**Verification of Title**

Certification of title for life settlements is more difficult than typical assets. The life insurance policy may have been owned by an individual or entity, usually for a period of several years, prior to being sold as a life settlement. As a result, it may be subject to liens, loans, divorce decrees, judgments and other encumbrances. If these encumbrances are not discovered prior to an investor's purchase of a life settlement, significant impairment to the value of the asset can result.

A policy can be owned by an individual, a corporate entity or by a trust, often an irrevocable life insurance trust, also known as an ILIT. ILIT's can be complex and are usually structured by trusts and estates experts. Whenever the purchase of a policy owned by a trust is contemplated, the trust agreement must be reviewed carefully for two particular issues: the state of the trust's situs or location and whether the current trustee(s) of the trust are properly authorized to act on behalf of the trust. The situs of the trust is important as it will determine the law that governs the transaction, and if the trustees are not properly authorized to act on behalf of the trust, the validity of the sale could later be called into question.

Even where a policy is owned by an individual, it is necessary to perform careful diligence to ensure there are no unseen pitfalls. A life insurance policy can only be obtained by individuals making representations about their health and financial status, hence running a basic background check on the policy owner is a simple step that can help ensure the quality-of-life settlement assets. For instance, a background check can reveal whether a policy owner has a judgment or liens levied against them that cloud title to the policy to be sold. If the seller does not affirmatively disclose this fact, it could remain undiscovered until some later date, causing serious issues for the then-owner of the policy. A background check can also show if the policy owner has filed for bankruptcy. And, notwithstanding a specific exemption for life insurance policies in the bankruptcy code, if the owner is currently in bankruptcy an order from the court approving the sale should be obtained to confirm that the bankruptcy trustee approves of the transaction and will not later try to unwind it.

It is also not unusual for one party to a divorce decree to have an obligation to keep a life insurance policy in force, with the other spouse as the beneficiary. Case law holds that the beneficiary spouse has an equitable interest in any life insurance policy subject to such an obligation, and it is probable that the insurance policy sale transaction could be unwound by the beneficiary spouse if it is undertaken without his or her consent. Similarly, in states that have martial property laws, if the existence of the policy was not disclosed to the court and addressed in the property settlement agreement, the former spouse will retain an interest in it. If that former spouse learns of the sale of the policy, he or she might have a cause of action to challenge the sale of the policy to an investor. Thus, any divorce decree must be carefully reviewed in order to ensure there is no cloud on the policy's title.

**Regulatory Compliance**

In the United States, life insurance is regulated by state governments, rather than by the federal government. As a result, and through the vicissitudes of the legislative process, it is the insurance departments of each state that regulate the life settlement industry. While the life settlements industry is only regulated at the level of the secondary market (the sale by the original policy owner to a licensed provider, not the sale of the policy from the provider to a fund), it is nevertheless critical to ensure that the original sale transaction was undertaken in compliance with pertinent law. The upside of state regulation is that transactions undertaken in compliance with pertinent law have the imprimatur of approval from the state; but there are downsides too. Chief among the downsides is the fact that, while the states' laws are based on one of a few model acts, no state's law is precisely identical to any other's. As a result, there are forty-five states that regulate life settlements transactions, but the specific law of each state varies from state-to-state. The failure of parties to comply with pertinent state laws during the origination process, such as proper licensing, mandatory disclosures, pricing regulations, etc., in the secondary market can result in challenges to the ownership and validity of the asset. Again, having counsel with experience with the differences between the states' laws, and the ability to determine if transactions were undertaken in compliance with those laws is imperative.

**Insurable Interest**

For a life insurance policy to be lawfully issued, a valid insurable interest must exist between the policy owner and the insured at the time the policy is issued. A person or entity has an insurable interest in another person where there is a special relationship between them such as marriage, family or certain financial relationships such as partners in a business. If there was not a valid insurable interest between the owner and insured at the time the policy was issued, then the policy is considered void ab initio (from the beginning) and can be declared void and rescinded by the issuing carrier, even decades after the policy was issued. Concerns about insurable interest were particularly prevalent as a result of the profusion of non-recourse premium-financed policies that flooded the secondary market in the early and mid-2000s. If a policy was originated from an improperly structured premium finance program, the owner may not have had an appropriate insurable interest at the time it was issued, thereby potentially rendering it null and void. This is another reason to ensure that experienced legal counsel assists investors in acquiring life settlements assets.

Thorough due diligence is a basic tenant of virtually every corporate transaction. Because of the relatively informal origin of the secondary market for life insurance, and its comparative nascency, however, the life settlement industry is only beginning to embrace a comprehensive due diligence regimen designed to ensure that the life settlement assets purchased by investors are of the highest quality possible. Any investor considering deploying capital into life settlement assets is well advised to make certain that any participants in the life settlement industry with whom they work has implemented a robust diligence program.

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