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**WET PAPER: GIVING THE SECONDARY  
MARKET FOR LIFE INSURANCE A BAD NAME**

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As the old saying goes, “When something seems too good to be true, it probably is.” In a controversial life insurance transaction known as a “Wet Paper” sale, this statement could not be any more applicable.

As a trusted professional advisor, it is important for you to understand the complexities of this marketplace and be able to explain the numerous pitfalls to your clients.

**What is Wet Paper?**

The most basic definition of Wet Paper is the purchase of a life insurance policy with the intent to sell that newly-issued policy to an investor prior to the expiration of the policy’s contestable period.

The policy itself insures the life of a senior citizen ordinarily with a high net worth. The funds used to bind the policy are lent to the primary owner by the investor who is about to become the secondary owner. The amount of the sale price typically ranges from 3-4 percent of the death benefit.

The name “Wet Paper” came about because the proverbial ink on the life insurance policies was still wet at the point when they were sold off to the investors (often times within 3-4 days of their issuance).

**Case Example**

ABC Investor, Inc. approaches Mr. Moneybags, a 78-year old retired entrepreneur. Mr. Moneybags has a net worth of \$15 million and owns only a \$1 million life insurance policy on his own life. ABC Investor, Inc. explains the Wet Paper concept and convinces Mr. Moneybags that he could make a quick buck.

Mr. Moneybags is taken through the life insurance underwriting process and learns that a carrier will issue a \$3 million Universal Life policy covering his life. The annual premium for this policy will cost \$200,000.

ABC Investor, Inc. subsequently enters a contract with Mr. Moneybags whereby ABC Investor, Inc. agrees to lend Mr. Moneybags \$200,000 (the annual premium cost) to bind the policy, and in exchange, Mr. Moneybags agrees to change the owner and beneficiary of the life insurance policy within 2 weeks after the policy is issued.

Once the changes take place, ABC Investor, Inc. agrees to pay Mr. Moneybags \$250,000 as Mr. Moneybags' consideration in entering into the Wet Paper sale. However, Mr. Moneybags only receives \$50,000 because he had to pay ABC Investor, Inc. for the \$200,000 loan.

Unfortunately, Mr. Moneybags passes away 5 years later. ABC Investor, Inc.'s total investment was therefore \$1,100,000 (5 years of premiums at \$200,000/year and \$100,000 to Mr. Moneybags to consummate the sale). ABC Investor, Inc. then collects the \$3 million death benefit (a net of \$1,900,000) as its hefty return on investment.

### **How Did The Paper Get Wet In The First Place?**

In order to understand where the Wet Paper marketplace is today, it is worthwhile to explore where it came from.

#### ***Viatical Settlements***

In the mid-1980's, investors began purchasing permanent life insurance policies (e.g. Whole Life, Universal Life, etc.) which covered the lives of individuals plagued with HIV and AIDS. These transactions were known as "Viatical Settlements." The sale price was an amount that was in excess of the cash surrender value of the policy, but less than its death benefit.

In a Viatical Settlement, the upside to the insureds was that they needed an immediate infusion of cash to help sustain their medical expenses and preserve as much quality of life as they possibly could. The upside to the investors was that the insureds had life expectancies of 2 years or less. Thus, the investors would only be obligated to pay premiums for a very short time and ultimately get a windfall (the entire death benefit) when the insured died.

The Viatical Settlement marketplace has essentially disappeared over the years because, as medical technology improved, individuals who contracted HIV began living longer. Viatical Settlements therefore became too risky of an investment. In addition, life insurance companies began including Accelerated Death Benefit Riders in their policies. These riders provided terminally ill individuals with the immediate right to receive a small percentage of their death benefit.

Today, a Viatical Settlement is the sale of a life insurance policy to an investor covering any insured (not just those with HIV or AIDS) who has less than a 2-year life expectancy. Most states, including Michigan, have legislation that regulates Viatical Settlements.

#### ***Life Insurance Settlements***

In the mid-1990's, while Viatical Settlements were losing momentum, investors became interested in purchasing life insurance policies covering individuals with an

impaired life expectancy (generally between 2-15 years). Enter the transaction known as a “Life Insurance Settlement” (also referred to as a “Life Settlement” or “Senior Settlement”).

Here, life insurance policies that were purchased with the intent to, among other things, protect one’s family or business, or pay for estate taxes, may no longer be needed or wanted, may be unaffordable or underperforming, or may be owned by a party with a desire for liquidity. Generally speaking, the insured looking to enter a Life Insurance Settlement has experienced a change in health or financial condition since the life insurance policy was purchased.

If the policy owner who encounters one of these situations owns a policy:

- that is out of the contestable period (typically 2 years),
- with a relatively low cash surrender value and annual premium obligation,
- that covers the life of an individual over the age of 65 with an impaired life expectancy,

then investors will offer an amount greater than the cash surrender value, but less than the death benefit to purchase the policy.

The same rules apply to a Life Insurance Settlement as a Viatical Settlement – once the owner and beneficiary change and the proceeds are paid to the seller, the investor has the on-going obligation to pay premiums until the insured dies. The investor then collects the death benefit.

Unlike Viatical Settlements, Life Insurance Settlements are regulated in only 28 states, and these do not include Michigan. Over the next few years, however, the majority of states will have some form of regulation covering this marketplace.

### ***Stranger Owned Life Insurance – Wet Paper’s Closest Relative***

At roughly the same time that Life Insurance Settlements became popular, investors thought it would be profitable if they could help originate life insurance policies on the lives of seniors, again with high net worth, who had the ability to obtain a significant amount of coverage, and then *after* the contestable period expired, purchase the policy from the original owner for a fraction of the death benefit. Like Wet Paper, the investor loans money to the original to pay the premiums.

The only significant difference between these transactions known as “Stranger Owned Life Insurance” (SOLI) (also known as “Investor Initiated Life Insurance” [IILI], “Investor Owned Life Insurance” [IOLI] or Non-Recourse Premium Financing) and Wet Paper sales, is that with SOLI, the investors wait until the policies are out of their contestable period before proceeding with their purchase.

The logic behind this is simple. It is riskier in a Wet Paper sale for an investor to purchase a policy in the contestable period because, if the insured dies during that period, it will be easier for a carrier to challenge a death claim. During the contestable period, a death claim may be successfully made on the basis of a material misrepresentation by the owner and/or insured in the application and underwriting process (e.g. the insured forgot to list his or her cardiologist and therefore the carrier was unaware that the insured had a severe heart condition at the time of application). However, once a policy is out of the contestable period, a successful challenge to a death claim may only be made in one of two situations. First, if the carrier proves that the owner and/or insured committed fraud (e.g. the insured purposely, and with the intent to hide a severe heart condition, failed to list his or her cardiologist as one of the insured's medical providers). Second, a carrier may argue that a particular policy lacked an insurable interest, and thus, it should be rescinded.

The main benefit of SOLI is that the original owner receives "free" life insurance during the contestable period. Thus, if the insured were to die during that period, the death benefit would be paid to the beneficiaries of the policy, less the principal of the loan given to the owner, plus interest. The original owner also realizes a benefit by having the right to pay off the investor at any time and remove the investor's lien on the policy. Conversely, in a Wet Paper sale, the policy is sold so fast that the beneficiaries are denied the chance of receiving the death benefit and the owner has no right to somehow maintain free and clear ownership of the policy.

### **What Are The Pitfalls To Entering A Wet Paper Sale?**

There are a number of pitfalls which you and your clients should be aware of with respect to Wet Paper sales (and to a similar extent, SOLI).

#### ***Lack Of Insurable Interest***

An insurable interest has been defined as a close relationship between the insured and beneficiary of a life insurance policy. The easiest examples include a husband and wife, partners in a business or a parent and child.

There are two simple questions one may ask when determining whether an insurable interest exists:

- 1) Do the beneficiaries of the life insurance policy need the death benefit?
- 2) Do the beneficiaries want the insured to continue living?

If the answer to both of these questions is "yes," then it is safe to assume that an insurable interest exists.

The law in most states, including Michigan, is that if an insurable interest exists at the moment a life insurance policy is issued, then an insurable interest always exists.

For example, in a Life Insurance Settlement, a policy may have been taken out years earlier for spousal protection (i.e. an insurable interest exists). Even if the policy is sold to an investor who obviously does not have a “close relationship” with the insured and would desire that the insured pass away as soon as possible, an insurable interest still exists.

On the other hand, in a Wet Paper sale, the policy is purchased with the intent to immediately sell it to an investor, not to protect someone with a close relationship to the insured, and within days of the sale, the new beneficiary would like to see the insured die as soon as possible. Hence, no insurable interest exists.

Here is the pitfall. Some Wet Paper contracts may provide the investor the right to go back against the original owner of the policy and/or the insured’s estate, if a death claim is successfully challenged by a carrier. In other words, if the investor expected to receive \$3 million upon the death of the insured and the carrier challenged the death claim on the grounds that no insurable interest existed, the investor could seek to recover \$3 million from the original owner and/or the insured’s estate.

### ***Fraud***

Life Insurance companies openly publicize the fact that they do not like any of the secondary market transactions explored above. Their main rationale is that, in the past, they expected a larger number of their policies to lapse or be surrendered before the insured died thereby avoiding the payment of a death claim. Now, however, once a life insurance policy is sold on the secondary market to an investor, that policy will be on the books until the insured dies and a death benefit will likely have to be paid.

In response to their concern, most life insurance companies have added a number of questions in their life insurance applications in an attempt to feel out whether the policy being purchased will be sold. One question directly asks whether the owner intends to sell the policy at any time. In order to consummate a Wet Paper sale, an applicant is probably coached by his or her agent to answer “no” to that question. No big surprise here – that is fraud.

Again, if the contract between the investor and original policy owner provides recourse to the investor in the event of a successful challenge to the death claim – in this case on the basis of fraud - your clients could be at risk. In recent months, New York Life and John Hancock have brought legal actions to challenge policies that were purchased for use in SOLI transactions. Clearly, the legal fees and costs that your clients could incur in such a lawsuit may pale in comparison to the upfront payments they received in their Wet Paper sales.

### ***Lack Of Future Insurability***

Each individual who applies for life insurance has a maximum threshold of coverage that will be issued.

For example, if an individual's total insurability is \$5 million, and that individual already owns \$3 million of coverage, arguably no carrier will issue more than \$2 million more of coverage.

In order to maximize everyone's gain in a Wet Paper sale, the parties want the largest possible policy to be issued. This has the effect of using up the insured's maximum amount of insurability. If the insured's financial situation changes after entering a Wet Paper sale and he or she desires to obtain more insurance coverage, there is a substantial likelihood that no carrier will issue more coverage because the insured is at capacity.

This risk applies not only to Wet Paper sales, but may also apply to any of the secondary market transactions explored above.

### *Hidden Tax Consequences*

There may be at least two tax consequences that are never discussed with a person before he or she enters a Wet Paper sale.

First, how will the IRS treat the money lent to the original owner to bind the policy? There is a question with any SOLI and Wet Paper transaction as to whether the IRS will accept the payment of the initial premium as a loan as contemplated by the parties. Some commentators have suggested that the IRS split dollar regulations could apply to these transactions resulting in the assessment of economic benefit tax liabilities to the insured.

There is also a suggestion that these transactions can be viewed as the purchase and sale of an option on an insurance policy. Under this theory, any upfront payment along with amounts "loaned" to pay the initial premium could be deemed an option payment. If the IRS were to pursue this theory, the amount subject to tax could greatly exceed the proposed upfront payment to the insured. In the case example above, the full \$200,000 initial loan could be deemed a taxable option payment. Moreover, the option theory also calls into question whether the transaction is subject to the securities law.

Second, since the question of how the transaction will be treated is open, the question of how any gain will be characterized is also open. Since life insurance is a capital asset, it is often argued that the payment should be treated as a capital gain. In a wet paper sale, the "asset" has not been held for more than a year so any gain should be treated as short-term capital gains at best. If the option or split dollar theory holds, the transaction may be treated as ordinary income.

Many SOLI transactions are supported by legal opinions from prominent law firms. These opinions need to be reviewed carefully by a client's advisors as most are heavily reasoned opinions that support their ultimate conclusion as "more likely than not" accurate. The client, in most cases, cannot assume that the legal opinion replaces an independent assessment of the tax consequences of the transaction.

## ***Ownership Concerns***

Throughout this article, the secondary market purchaser has been referred to as the “investor.” But, who is the investor? The short answer is: “It depends.”

In Life Insurance Settlements, an overwhelming majority of policies are purchased by large institutional investors. These include hedge funds, private equity firms and/or investment banks. Under this model, there is more than arm’s length between the seller and the investor. In other words, the investor rarely, if ever, knows the identity of the insured whose policy it now owns.

In SOLI transactions, there are significantly less institutional investors who will purchase premium-financed policies. However, a number of extremely wealthy private investors willing to take on the risk have entered this marketplace as a way to diversify their investment portfolios. Thus, when a private investor is involved, chances are good that the identity of the insured is known.

Finally, in Wet Paper sales, there are comparatively the lowest number of institutional investors and the largest number of private investors. These transactions therefore involve little to no anonymity.

The scary truth of the matter is that if a private investor (as opposed to institutional investor with more resources) cannot resell the policy and unexpectedly is forced to pay premiums for years longer than expected, a substantial decline in the financial condition of the investor may lead to a greater chance of foul play (e.g. the investor would hasten the insured’s death).

While this is a risk that exists in any of the secondary market transactions, this risk is greater in Wet Paper sales based upon the players involved.

## **How Do Industry Members View Wet Paper Sales?**

Most players in the secondary life insurance marketplace dislike Wet Paper sales. The most well recognized voice in the Life Insurance Settlement marketplace, The Life Insurance Settlement Association (the LISA), has stated:

The LISA and its members have adopted a strong position against transactions involving the sale of newly issued life insurance policies that were purchased with the sole intent to sell. Without a showing of an unanticipated change in the health and/or financial condition of the owner of the policy, the members of the LISA will not enter into viatical settlement and/or life settlement transactions within two years of the issue date of a life insurance policy, or such other period of time to be determined by law, not to exceed the contestable period.

Similarly, The Life Insurance Finance Association (LIFA) has stated that it agrees and supports the existing rule found in the Viatical Settlements Model Act that objectively addresses the prohibition on the sale of a life insurance policy during the first two years of the policy, thus preventing the purchase of life insurance for the purpose of a “wet paper” sale to persons who do not have an insurable interest in the insured.

### **Are Wet Paper Sales Regulated?**

North Dakota (a state with 4 known Life Insurance Settlements in the last year) recently passed a law that prohibits Wet Paper sales, SOLI and certain Life Insurance Settlements. This is the only law in the United States of its kind.

The relevant provision of the North Dakota law essentially states that no life insurance policy may be sold to a third party within the first 5 years of its issuance. This obviously does away with Wet Paper sales because those take place within the first 2 years of issuance. It also impacts SOLI, because those sales are meant to take place within a year or two after the contestable period expires (i.e. 3-4 years after the policy’s issuance). Finally, it impacts Life Insurance Settlements because a policy owner who no longer has a need for the insurance would have to wait up to 3 years beyond the contestable period to sell his or her policy.

It is no surprise that LISA and LIFA strongly oppose the passage of this law and hope that the judiciary in North Dakota one day rule that the law is unconstitutional (i.e. it violates a person’s most basic property rights). The major proponent of this law was North Dakota’s Insurance Commissioner, Jim Poolman. Mr. Poolman has also been arguing vehemently for the passage of a revised version of the Model Viatical and Life Settlements Act that would be identical to the North Dakota law. Mr. Poolman’s hope is that the Model Act then gets adopted by all 50 states. This is not likely to happen.

However, in an effort to prohibit Wet Paper sales and SOLI, one of the latest proposed amendments to the Model Act stated that no life insurance policy may be sold in the in the first 5 years of its issuance if the premiums used to pay for the policy were financed by a third party. Proponents of both Wet Paper sales and SOLI do not support this amendment. However, those who support Life Insurance Settlements, including LISA, believe that this amendment is reasonable, as it would still allow legitimate Life Insurance Settlement transactions to take place.

### **Conclusion**

Wet Paper sales, and to a similar extent, SOLI transactions, should raise red flags if encountered by you or your clients. Each of these secondary market “schemes” may lead to a number of hidden legal and/or tax consequences. If you have a client intent on entering a Wet Paper sale, the best advice you could give would be to have the entire transaction reviewed prior to closing by a legal, tax and insurance advisor. An insurance

advisor could, for example, explain to your client whether the transaction would result in your client's inability to obtain more life insurance at some point in the future.

Life insurance is an important financial asset and it is in your client's best interest to have all of the facts before entering into any secondary market transaction. A client that fails to proceed in this fashion will simply be operating from a position of ignorance vis a vis the investor unless the entire situation is evaluated first.

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