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WALKING THE FIDUCIARY TIGHTROPE

New ruling forces advisers to balance duty in a competitive market.

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When it comes to investment advisers managing assets, regulators tend to take matters very seriously. Recent examples of fraud, mismanagement, and lax standards have had a resounding impact on the financial services industry, drawing to light the need for clearer definitions as to the roles and responsibilities of advisers.

That's where fiduciary duty comes in—a very serious sounding term with an even more important definition. What exactly is fiduciary duty and who does it apply to? This article will focus on the fiduciary responsibilities of advisers, discuss recent regulatory changes and new requirements, and highlight the importance of understanding the litigation risks of new opportunities like life settlements.

FIDUCIARY DUTY

The issue of fiduciary duty has moved to forefront of the financial services industry with many advisers walking a fiduciary tightrope, delicately balancing their roles, responsibilities, and litigation risks in a competitive market. Let's take a closer look.

Roles

The Foundation for Fiduciary Studies describes a fiduciary as someone who manages the property of others, exercises discretionary authority or

control over assets, and serves as a trusted professional offering consistent and comprehensive investment advice. They are the more than five million advisers who manage other people's money through endowments, foundations, investment portfolios, retirement plans, and trusts (i.e. accountants, estate planners, financial planners, investment advisers, lawyers, private bankers, and trustees). Fee based broker-dealers were also added to this group in April of this year, after a ruling by The District of Columbia U.S. Court of Appeals in a landmark case between the Financial Planning Association (FPA) and the Securities and Exchange Commission (SEC) regarding the issue of fiduciary duty.

Responsibilities

What is a fiduciary's duty? General guidelines issued by the FPA, the National Association of Personal Financial Advisers (NAPFA) the Investment Adviser Association (IAA), and the SEC call for advisers to:

- Act in a competent, professional, and ethical manner employing integrity, objectivity, fairness, diligence, and confidentiality.
- Seek to obtain the best price/execution for clients' assets.
- Provide proper disclosure.

Tip: To learn more about the responsibilities of a fiduciary, visit the Founda-

tion for Fiduciary Studies http://www.fi360.com/main/foundation_studies_us_practices_advisors.jsp or for a complete review of the new SEC's guidelines for fee based broker-dealers, visit <http://www.sec.gov/divisions/investment/advoverview.htm>.

Litigation Risks

What does fiduciary duty have to do with life insurance assets? Proponents of the secondary life insurance industry have long argued that the responsibilities pertaining to fiduciary duty apply to advisers with clients owning life insurance assets. Their argument is generally based on five beliefs:

- Life insurance is an asset and can be bought or sold as outlined in the 1911 Supreme Court ruling in *Grigsby v. Russell*.
- As an asset, which is often included in wealth management services like estate planning, its value may increase or decrease in the primary or secondary markets and therefore should be professionally managed.
- If such assets no longer meet original investment criteria or are underperforming, then a client must be notified.
- If a client seeks to lapse or surrender a life insurance asset, then objective alternatives must be disclosed.
- When pursuing a fair market valuation, diligence to obtain the best price should occur.

But what about those who disagree with these beliefs? Although the number of captive agents and advisers currently prohibited from engaging in such transactions by their carrier or broker-dealer are decreasing, there still remain a sizeable number who are. These advisers most certainly face an increased risk for litigation due to breach of fiduciary duty, in addition they also may find that any errors and omissions (E&O) protections they currently have may fail to cover.

Making the Case

Consider this scenario, a senior high-net-worth client experiences a change in their life insurance needs and seeks advice as to their options. If the life settlement option is not disclosed and the client lapses or surrenders their policy, only later to discover they could have potentially earned significantly more through a life settlement transaction imagine what their response will be.

KahnGauthierSwick LLC, a New Orleans based law firm specializing in consumer and securities fraud, suggests that clients who believe their adviser acted improperly will naturally pursue litigation to receive compensation for their losses. Evidence of this is supported in statistics released by the Financial Industry Regulatory Authority (FINRA), where breach of fiduciary duty ranks as the top complaint by consumers based on cases arbitrated against advisers.

Unfortunately, many advisers are unwittingly increasing their risks for litigation. Did you know that more than \$1.1 trillion dollars worth of life insurance was lapsed in 2005 according to statistics reported by the Insurance Information Institute (III)?

Bottom line, if you have senior age clients who own life insurance assets then you have a fiduciary responsibility to incorporate life settlements into your review process, provide proper disclosure of available options, and, if necessary, help them obtain the best price available through the secondary market.

LIFE SETTLEMENTS

So what exactly are life settlements and how do they work? A life settlement is the sale of an unneeded or unwanted life insurance policy to a provider or institutional investor for a cash settlement. The new owner pays ongoing premiums and collects future benefits. The process for sellers is straight forward—no medical exams, offers received are greater than the cash surrender value, and best of all, no usage restrictions on the proceeds.

The process typically begins with a policy owner consulting with their trusted adviser. If the decision to sell their unneeded or underperforming life insurance is made, then the adviser contacts a life settlement specialty broker or provider, who utilizes various ancillary companies to facilitate the sale of a life insurance policy, based on the criteria set forth by institutional investors. Sellers go on to receive a lump sum cash payment greater than the policy's surrender value but less than the face amount, while providers or institutional investors maintain premium payments and collect future death benefits.

The market is in the midst of high growth and will continue its upward trend as the baby boomer generation enters retirement. Bernstein Research predicts that by year 2030, there will be 72 million seniors age 65+ who will control \$800 billion of life insurance, of which \$161 billion would be eligible for life settlements.

Screening Tips

When should a life settlement be considered? The number of appropriate reasons keeps growing, but most center on changing needs like retirement, medical condition change, divorce/death of a spouse/beneficiary, underperforming investments/estates, or sale/bankruptcy of a business.

Who is a candidate? Generally seniors age 65 or older who have experienced a recent health change, own a transfer-

able life insurance policy or convertible term policy, with a face amount greater than \$100,000, and from a well-rated carrier.

GETTING STARTED

Making the move to life settlements is easy. Simply incorporate appropriate screening measures into your regular client reviews and you are on your way to getting started. As you will learn, life settlements are not for everyone, in fact only select clients will likely meet qualifications. Before pursuing any transactions, be sure to familiarize yourself with these important issues:

- **Licensing/Authorization** — A license/authorization is required to broker the sale of a life insurance policy owned by a resident of AK, AR, CO, CT, FL, GA, IA, IN, KS, KY, LA, MD, ME, MS, MT, NC, ND, NE, NV, NJ, OH, OK, PA, TN, TX, UT, VA and Puerto Rico. More states are expected to follow.

- **Work with Professionals** — Great care should be taken when deciding which life settlement professionals to work with. The number of life settlement specialty brokers and providers grows daily. Be sure your due diligence includes comprehensive background checks of corporate officers and reviews of licensure, anti-fraud protection, and consumer privacy measures. Also verify that E&O coverage for advisers is provided.

- **Taxes** — Presently there are no Internal Revenue Code provisions or IRS rulings pertaining to the specific income taxation of life settlements. In light of this, many authorities follow these guidelines: The proceeds from a life settlement are tax free up to the amount of premiums paid for the policy. The difference between that amount and the cash surrender value is generally taxable as ordinary income. Amounts received in excess of cash surrender value are generally taxed as capital gain. As with any transaction, it is strongly recommended that a policy-

holder considering selling his/her policy consult a professional tax adviser for questions regarding tax consequences.

- **Commissions** — Demands for transparency and sound business practices by legislators and institutional investors are forcing many to carefully consider the commissions paid to an adviser for brokering the life sale of a client's life insurance. General industry

payouts according to Conning Research & Consulting typically equal 6 percent of a policy's face amount. More and more states are requiring disclosure of such information.

As the number of advisers walking the fiduciary tightrope increases, those who clearly understand their roles, responsibilities, and litigation risks will be better positioned in a competitive

market, especially after adding new opportunities like life settlements to their services.

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CASE EXAMPLES*

EXAMPLE A: CHANGES TO ESTATE PLAN

Insured: **76-year-old female**

Policy: **Universal Life**

Face amount: **\$2,300,000**

Surrender value: **\$15,067**

Cash to seller: **\$83,054**

EXAMPLE B: PREMIUMS BECOME A BURDEN

Insured: **71-year-old male**

Policy: **Universal Life**

Face amount: **\$5,000,000**

Surrender value: **\$0**

Cash to seller: **\$1,218,904**

***Disclaimer: Examples are for educational purposes and not an indicator of purchase price. Average price paid to a policy owner is approximately 20 percent of a qualifying life insurance policy's face amount based on a previous 12-month period.**