

# SENATE STAFF ANALYSIS AND ECONOMIC IMPACT STATEMENT

(This document is based on the provisions contained in the legislation as of the latest date listed below.)

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Prepared By: Banking and Insurance Committee

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BILL: CS/SB 1616

SPONSOR: Banking and Insurance Committee and Senator Atwater

SUBJECT: Insurable Interests: Life Insurance and Life Annuity Based Certificates

DATE: April 20, 2005

REVISED: \_\_\_\_\_

	ANALYST	STAFF DIRECTOR	REFERENCE	ACTION
1.	<u>Knudson</u>	<u>Deffenbaugh</u>	<u>BI</u>	<u>Fav/CS</u>
2.	_____	_____	<u>ED</u>	_____
3.	_____	_____	<u>RC</u>	_____
4.	_____	_____	_____	_____
5.	_____	_____	_____	_____
6.	_____	_____	_____	_____

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## I. Summary:

Senate Bill 1616 authorizes the creation of charitable life and annuity trusts authorized by state universities. The bill allows a trust, partnership, limited liability company, or similar entity (entity) to own or purchase life insurance on a consenting insured. Such an arrangement is referred to as a Charitable Life and Annuity Trust or Life Insurance and Life Annuity Based Certificate (LILAC). The trust, partnership, LLC, or similar entity must be approved by a public or private university in Florida which receives state funds, or an affiliated foundation of the university. The following requirements apply to the charitable life and annuity trust:

- The approved trust similar entity must be, at least in part, formed for the purpose of generating funds for private or public universities in Florida which receive state funds, or for the affiliated foundation of the university.
- The approved entity must obtain a combination of life insurance policies and annuity contracts on the life of consenting individual insureds. Payments under annuities must be used to fund life insurance policy premiums for the second and succeeding years.
- At least 99 percent of all funds used to procure life insurance and annuities must be from either qualified institutional buyers, or proceeds and investment income from annuities or other insurance policies procured with funds from qualified institutional.
- Investment in the entity must be made pursuant to a nonpublic offering or a public offering through a registered broker/dealer under the Securities Exchange Act of 1934.
- A Securitized transaction is required for the institutional buyer to have any interest in the life insurance policy, annuity, or benefits.
- The university must reasonably anticipate receiving death benefits from each life insurance policy at the time the approved entity acquires the life insurance policies. The expectation of benefits is after the return of the amount invested and yield accrued and payable to the qualified institutional buyers (whose monies were used to fund the

- purchase of the life insurance policies) in accordance with the securities offering or other disclosure materials.
- Disclosure must be made in the securities offering of the reasonably anticipated death benefit proceeds from the life insurance policies that are to be received by the university.
  - Both the individual insured and the university or its affiliated foundation must be informed of the minimum percentage or proceeds of the life insurance policy reasonably anticipated to be paid to the university or its affiliated foundation. Notice must be made prior to the purchase of life insurance on the individual insured by the approved entity.
  - The individual insured must have a net worth of at least \$5 million at the time of the transaction, and provide an affidavit stating that only the specified university received any monetary remuneration in return for the insured's consent to purchase the life insurance policy, except for third-party expenses in connection the grant of consent.
  - An insurance or annuity contract purchased via a charitable life and annuity trust arrangement to be purchased through an agent who is licensed in Florida.
  - Transactions to procure or fund life insurance policies or annuity contracts are prohibited unless prior approval has been given by the DFS in consultation with the OFR and OIR. Prior approval may only be given if the planned transaction:
    - Meets the requirements of paragraph (a) [see above],
    - Is fiscally prudent, and
    - Is found to be in the best interest of the people of Florida.
  - The approved trust, partnership, LLC or similar entity cannot engage in the following actions unless the entity applies for and obtains a license under s. 626.9912, F.S., (a license as a viatical settlement provider) prior to the action:
    - Life insurance policies procured by the entity cannot be assigned or transferred
    - The ownership or beneficiary designation in favor of the entity of the life insurance policies may not be changed
    - A policy loan under the life insurance policies cannot be taken out by the entity
    - All transactions under s. 626.9912, F.S., are subject to Ch. 517 (Securities transactions).

This bill substantially amends the following section of the Florida Statutes: 627.404.

## II. Present Situation:

### Charitable Life and Annuity Trusts

Life insurance and life annuity based certificates combine a life insurance policy and a premium financed annuity investment. Under SB 1616, a state university or its foundation approves a trust, partnership, LLC or similar entity that is invested in by investors in exchange for a market-based, fixed rate of return as well as a return of the investor's capital at the conclusion. The investor capital is used to purchase life insurance policies and annuity contracts on the lives of consenting individuals who designate the University or its foundation as recipients of an interest in the trust. Monies from the annuity contracts (often invested in a mutual fund or other investment) are used to pay the life insurance premiums on consenting persons (the insured), with any remaining investment income paid to the investors as their fixed rate of return. Upon the death of the insured, the life insurance pays the value of the policy to the trust. The policy

proceeds are first used to reimburse the investors for their original capital investment. If any funds remain, they are paid to the university or its foundation.

The charitable life and annuity trust transaction is an example of arbitrage. Arbitrage is the simultaneous purchase of a security or commodity in the hope of making a profit on price differences in the different markets.<sup>1</sup> The arbitrager takes off-setting positions in the same or similar securities in order to profit from small price variations. Charitable life and annuity trusts are premised on the existence of an arbitrage between a life insurance policy and an annuity, where the cost of the annuity is less than the death benefit from a comparable life insurance policy.<sup>2</sup> Charitable life and annuity trusts have been approved in Nebraska, North Carolina, Tennessee, Texas, and Virginia. Louisiana defeated similar legislation.

### **Life Insurance**

Life insurance is a contract between the holder of a policy and an insurance carrier whereby the carrier agrees, in return for premium payments, to pay a specified sum (the face value or maturity value of the policy) to the designated beneficiary upon the death of the insured.<sup>3</sup> The two most basic types of life insurance are a whole life insurance policy and a term life insurance policy. For a whole life insurance policy, premiums are collected during the life of the insured, with a payout occurring at the death of the insured. The premium for whole life insurance remains the same throughout the life of the policy, in large part because the policy accumulates a “dividend” cash value which permits the insurance company to maintain the same premium level year after year. The insured can also withdraw or borrow against the cash value accumulated by the policy. Term insurance, on the other hand, offers insurance protection for only a specified or limited period of time, though the policy is often renewable from term to term. Term insurance usually is less expensive than a whole life policy, though the premium cost for term insurance increases as the age of the insured increases.

### **Annuities**

An annuity is generally defined as a periodic payment to an individual that continues either for a fixed period of time or for the duration of a designated life.<sup>4</sup> An annuity is designed to systematically liquidate a principal sum, as the insurer agrees to pay the annuitant (beneficiary) a certain sum over a period of time, which in the context of life insurance is either the life of the annuitant or a specified number of years. The purpose of an annuity is to protect the annuitant against the possibility that he or she will outlive current sources of income, or to supplement sources of income.<sup>5</sup> Thus, an annuity is often used to prepare for retirement. Two types of annuity are the fixed annuity and the variable annuity. A fixed annuity guarantees fixed payments, either for life or for the specified policy period, to the annuitant (beneficiary). A variable annuity calls for payments to the annuitant in varying amounts, depending on the success of the investment policy of the insurer (the investment is often in a mutual fund or other

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<sup>1</sup> *Deluxe Black's Law Dictionary* 104 (6<sup>th</sup> ed. 1990).

<sup>2</sup> Proponents of the legislation assert that the total net cost of the annuity used in the transaction is approximately 95% of the death benefit in a whole life insurance policy.

<sup>3</sup> *Deluxe Black's Law Dictionary*, Page 805 (6<sup>th</sup> Edition 1990).

<sup>4</sup> Robert W. Klein, *A Regulator's Introduction to the Insurance Industry* pg A-2 (1999).

<sup>5</sup> See Klein at pg. 4-13.

investment instruments). Annuities can also be set up to begin periodic payments immediately, or defer the payments to a later date. One advantage to a deferred annuity is that investment growth in the annuity is tax-free until paid out to the annuitant.

### **Insurable Interest in Life Insurance**

A fundamental concept in insurance is that the beneficiary of an insurance policy must have an insurable interest—a reasonable expectation of a monetary benefit from the continued well-being of the life or property being insured. The requirement of an insurable interest exists to prevent gambling, reduce moral hazard, and measure insured loss.<sup>6</sup> In the context of life insurance, the insurable interest prevents purchasing insurance on others in the hope that you will get lucky and they die, and protects the hypothetical purchaser from the temptation to create a situation where he or she will be able to collect on the policy. The concept of insurable interest can be found in the Florida Statutes at s. 624.404 and 624.405.

### **Charitable Organizations**

Under s. 627.404(2), F.S., a charitable organization that meets the requirements of a not-for-profit organization under s. 501 (c)(3) of the Internal Revenue Code may own or purchase life insurance on an insured who consents to the ownership or purchase of that insurance.<sup>7</sup> This is an exception to the general rule that the beneficiary must have an insurable interest in the insured. The charitable organization would therefore own an insurable interest in the insured, e.g., a lawful and substantial economic interest in the subject of the insurance.

There are currently no provisions in Florida law to allow a not-for-profit organization<sup>8</sup> to approve a separate and independent for-profit entity, e.g., trust, partnership, or limited liability company, to obtain or procure life insurance policies and annuity contracts on the life of an individual insured.

## **III. Effect of Proposed Changes:**

**Section 1.** Creates subsection (3) of s. 627.404, F.S.

Paragraph (a) of s. 627.404(3), F.S.

The bill authorizes a trust, partnership, limited liability company, or similar entity (entity) to own or purchase life insurance on an insured that consents in writing to the ownership or purchase of the insurance. Such an arrangement is referred to as a Charitable Life and Annuity Trust or Life Insurance and Life Annuity Based Certificate (LILAC). The trust, partnership, LLC, or similar entity must be approved by a public or private university in Florida which receives state funds, or an affiliated foundation of the university that either meets the requirements of s. 501(c)(3) of the

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<sup>6</sup> See Klein at pg. 2-7.

<sup>7</sup> Under s. 627.404(1), F.S., an insurer is entitled to rely upon the statements made by an applicant for insurance relative to the insurable interest which such applicant has in the insured.

<sup>8</sup> Or organizations to which charitable contributions could be made under ss. 170 (c)(1) - (3) of the Internal Revenue Code of 1986, as amended. Organizations described in 170 (c) include various public and charitable entities.

Internal Revenue Code of 1986 as amended, *or* can receive a charitable contribution under s. 170(c)(1), (2), or (3) of the Internal Revenue Code of 1986, as amended.

The LILAC arrangement between the entity purchasing life insurance or an annuity contract, the insured on whom the insurance or contract is purchased, and the university are subject to the following requirements contained in paragraph (a):

*Purpose:* The approved trust, partnership, LLC or similar entity must be, at least in part, formed for the purpose of generating funds for one or more designated private or public universities in Florida which receive state funds, or for the affiliated foundation of said university.

*Procurement of life insurance policies and annuity contracts:* The approved trust, partnership, LLC or similar entity must procure, or cause to be procured a combination of life insurance policies and annuity contracts on the life of consenting individual insureds. Payments under the annuity contracts must be used (and reasonably anticipated) to fund the premiums on the life insurance policies for the second and succeeding years.

*Source of funding to purchase life insurance and annuities:* At least 99 percent of all funds used by the entity to procure life insurance and annuities must be from qualified institutional buyers as defined by Rule 144A of the Federal Securities Act of 1933, or proceeds from annuity contracts or other insurance policies procured with funds invested by qualified institutional buyers as well as the interest income.

*Investment in approved entity via registered broker/dealer:* The investment in the entity by qualified institutional buyers must be made pursuant to a nonpublic offering or a public offering through a registered broker/dealer under the Securities Exchange Act of 1934.

*Securitized transaction required for institutional buyer to have interest in life insurance policy, annuity, or benefits:* A qualified institutional buyer may not procure or hold any direct interest in the life insurance policies or annuity contracts, or any of the benefits from such policies or contracts, except as part of a securitized transaction that is subject to Ch. 517, F.S., or federal securities laws.

*Reasonable anticipation of receiving benefits:* A qualifying university must reasonably anticipate receiving death benefits from each life insurance policy of the individual insured at the time the approved entity acquires the life insurance policies. The expectation of benefits is after the return of the amount invested and yield accrued and payable to the qualified institutional buyers (whose monies were used to fund the purchase of the life insurance policies) in accordance with the securities offering or other disclosure materials.

*Disclosure of expected benefits in securities offering:* Disclosure must be made in the relevant securities offering of the reasonably anticipated minimum percentage or amount of death benefit proceeds from the life insurance policies that are to be received by the designated university.

*Disclosure to insured and university:* Both the individual insured and the university or its affiliated foundation must be informed of the minimum percentage or proceeds of the life insurance policy reasonably anticipated to be paid to the university or its affiliated foundation.

Notice must be made prior to the purchase of life insurance on the individual insured by the approved entity.

*Affidavit:* The individual insured must provide an affidavit stating that only the specified university received any monetary remuneration in consideration for the insured's consent to purchase the life insurance policy, except for third-party expenses incurred in connection the grant of consent.

*Purchase from Florida licensed agent:* A life or insurance product purchased in conjunction with a LILAC must be purchased through a Florida licensed agent.

*Insured's minimum net worth at transaction:* The insured must have a minimum net worth of \$5 million at the time the charitable life and annuity trust transaction is entered into.

Paragraph (b) of s. 627.404(3), F.S.

*Prior approval of Department of Financial Services for transactions to procure or fund life insurance policies or annuity contracts:* Transactions to procure or fund life insurance policies or annuity contracts are prohibited unless prior approval has been given by the DFS in consultation with the OFR and OIR. Prior approval may only be given if the planned transaction:

- Meets the requirements of paragraph (a) [see above],
- Is fiscally prudent, and
- Is found to be in the best interest of the people of Florida.

Once the transaction is approved the entity (trust; etc) has an insurable interest in the life of the individual insured.

Paragraph (c) of s. 627.404(3), F.S.

*Management of life insurance policies by the approved entity:* The approved trust, partnership, LLC or similar entity cannot engage in the following actions unless the entity applies for and obtains a license under s. 626.9912, F.S., (a license as a viatical settlement provider) prior to the action:

- Life insurance policies procured by the entity cannot be assigned or transferred
- The ownership or beneficiary designation in favor of the entity of the life insurance policies may not be changed
- A policy loan under the life insurance policies cannot be taken out by the entity

All transactions under s. 626.9912, F.S., are subject to Ch. 517 (Securities Transactions).

#### **IV. Constitutional Issues:**

A. Municipality/County Mandates Restrictions:

None.

B. Public Records/Open Meetings Issues:

None.

C. Trust Funds Restrictions:

None.

V. Economic Impact and Fiscal Note:

A. Tax/Fee Issues:

None.

B. Private Sector Impact:

Proponents<sup>9</sup> of SB 1616 assert that charitable life and annuity trusts provide a means by which Florida's universities can take advantage of an arbitrage transaction to raise additional funds with a minimum of risk. The proponents state that upon the death of the insured, the university receives all of the profit from the arbitrage upon the payout of the life insurance policy after the qualified institutional buyers (investors) are reimbursed their initial investment. Neither the university nor the insured seeking to make a donation to the university have to spend any money to set up the charitable life and annuity trust. It is the investors who finance the annuity and life insurance. Proponents also state that a number of safeguards against fraud and abuse are present in the bill, including restriction of the program to state universities, requiring that investors be qualified institutional buyers under Securities and Exchange Commission rules, insureds taking part in the program must sign an affidavit consenting to their participation, and DFS approval prior to each transaction. The proponents of the bill assert that under current law, charities are permitted to have an insurable interest in an insured person's life insurance policy. As such, the charitable life and annuity trust amounts to a new application of this provision in current law.

Opponents<sup>10</sup> of SB 1616 state that charitable life and annuity trusts turn life insurance policies into commodities and investment opportunities by third parties that have no insurable interest in the insured party. The opponents assert that insurable interest laws have existed well over a century in Florida and are designed to ensure that life insurance serves its public purpose—to insure that family members and business partners and associates are not placed in economic distress by the death of the insured. Those opposing the bill also state that these arrangements end up converting life insurance policies into commodities for third parties who are able to receive an annuity income stream, and who use the policy proceeds to guarantee their original investment, while leaving a small percentage to the university. Finally, the opponents of the bill have voiced concern that LILACs may threaten the current Federal tax-exemption for life insurance death benefits if such policies become viewed as an investment commodity. The Office of Insurance Regulation has also voiced concerns regarding LILACs, stating that the bill contains no guarantee that any proceeds would remain to be distributed to the university

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<sup>9</sup> Proponents of the legislation include the AIG, Berkshire, Jefferson Pilot, and AXA companies, the Lilac Capital Corporation (the developers of charitable life and annuity trusts), and Union Bank of Switzerland (provides the annuity premium financing).

<sup>10</sup> Opponents of the legislation include the American Council of Life Insurers, the National Association of Insurance and Financial Advisors, and the National Conference of Insurance Legislators.

at the end of the transaction, in which case the only persons deriving a benefit would be the private investors, not the insured or the university.

C. Government Sector Impact:

None.

**VI. Technical Deficiencies:**

None.

**VII. Related Issues:**

None.

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This Senate staff analysis does not reflect the intent or official position of the bill's sponsor or the Florida Senate.

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## **VIII. Summary of Amendments:**

None.

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