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PREMIUM FINANCE STRATEGIES & OUTLOOK FOR 2022

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Background

In a recent estate plan review with a corporate client, I was introduced to a very unique and lucrative concept. As an employee benefits attorney, I regularly draft documents to support buy-sell agreements, executive benefit plans, and nonqualified deferred compensation plans. While company-owned life insurance ("COLI") has not always been an everyday part of my practice, COLI is becoming increasingly common and desired by many corporations and individuals.

There is one area of corporate life insurance planning that has typically concerned me—how does a short-term problem with a relatively simple solution (term insurance), get solved when it becomes a long-term or perpetual issue? These situations often arise with buy-sell arrangements when the owners are owners until death. Drafting a buy-sell agreement is a basic process, but funding the solution or the corporate buyout can be financially cumbersome if the related strategy is not carefully crafted or planned.

When there is a permanent insurance need, permanent insurance should be placed. After weighing in ages and health considerations as part of the equation, some of the insurance premiums can become quite expensive. The negative impact resulting from such high premiums is that the premium payments are a debit on the ledger with very little benefit unless someone dies during the first few years of the contract life. Some policies take 7 to 10 years before the parties even reach a break-even point.

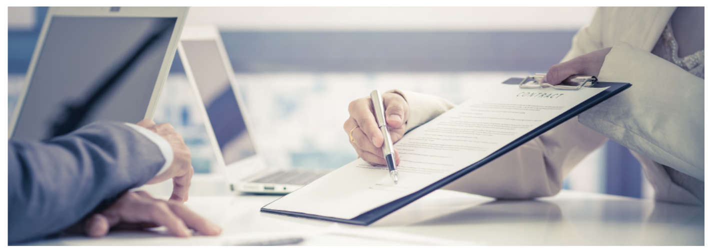
Premium Financing Concept

What if I told you there is a way to purchase life insurance and make related premium payments without materially depleting your assets so that such assets can continue to generate wealth? This is certainly possible and is known as "premium financing". By implementing a premium financing strategy, my corporate client will not be making the premium payments directly but will instead enlist a lending institution to make premium payments on its behalf.

The following is a brief illustration of the premium financing concept:

Suppose my client's key executives, 58- and 60-year-old males, each require a $5 million life insurance policy to fund or fulfill their buy-sell obligations as part of a stock redemption plan. Rather than advising my client to directly pay the applicable premiums, I generally advise the company to utilize premium financing and engage the services and strategies offered by a bank.

If my corporate client paid these premiums directly or in a traditional sense, the combined annual premium to fund each of the key executives' lives would be $318,072. These premium payments are due every year until one or both executives have passed away. It is not difficult to see what the issues are at this level and what has concerned me over the years.



At this point in the analysis, I consider the following financial implications for my client:

Do I advise my client to pay the full annual premium amount, or do I advise my client to simply pay the annual interest on the premium and utilize premium financing to fund the difference? Current interest rates for this plan in 2021 are approximately 2.35%, with an annual interest cost in year one of $7,473.28. This gives my client the flexibility to retain $310,598.72 as corporate assets yet still obtain the requisite life insurance protection.

Legal Issues Related to Premium Financing

The premium financing concept is invaluable, as long as the key dynamics, complexities, risks and legal components are recognized and considered prior to engaging this strategy.

With premium financing, the first goal is to research and engage a life insurance company to insure my client. We then engage the services of a bank that has the ability to properly structure a design to fit my client's specific needs. It is essential that the insurance company, lending institution, and legal counsel are all on the same page with regard to the overall strategy and goals. Typically, I prefer to have 8 to 10 banks and 8 to 10 insurance companies as potential options. This creates leverage and ultimately the best deal for my client. While my client is going through medical underwriting, I will typically complete and submit a file of financial documentation for lender approval. This allows the bank to obtain adequate assurances that the proposal is financially suitable.

Once approved for the life insurance and loan, the bank will research the amounts to be loaned from year one to year three. The bank will make certain assumptions regarding the cash growth, but ultimately there will be a shortfall between the amount the bank has loaned and the amount of cash available in the life insurance contract. For the first several years while the policy is growing, the bank will hold a collateral assignment on the policy. The bank does not want to be left "underwater" in any scenario, so it will typically require the client to post collateral to cover the bridge between the policy surrender value and the loan amount. After year three, the parties will simply need to review the difference between the surrender value and loan amount every 12 months and adjust the value of the collateral accordingly.

Collateral may be pledged in many forms, including: stock or other investment instruments; real estate; investment properties; and even other life insurance policies. If it is more efficient for the client, we may decide to obtain a letter of credit ("LOC") backing the pledged asset so that the client and bank can continue with the loan process unimpeded. For example, if my client wants to pledge a portion of its investment account with ABC Holdings, we will attach the LOC to the specific portion of the account pledged. At the same time, the investment account will continue to be managed at ABC Holdings with no restrictions on trading. Annually, the bank issuing the LOC will want to perform its own review to ensure that its representations in the LOC are still financially accurate and supported. In most financed structures, the bank will be paid in full out of a portion of the death benefit, although the option to payoff the loan earlier typically exists.

Without getting into the precise legal details related to the pledge of collateral or financial guarantee of the insured, I do want to point out that in order to minimize any potential gift tax exposure or incident of ownership, I make sure to include documentation in my client's files demonstrating that the loan could have been obtained without the pledge or guarantee—but at a higher interest rate.

Federal tax law takes the position that a contingent liability cannot be taken into account for tax purposes unless it matures; thus, a contingent liability can only result in tax consequences when it becomes fixed or is paid (e.g., the borrower defaults on the loan). Given the considerable amount of due diligence performed prior to implementing a premium finance strategy, I am confident that any risk of default is extremely low.

With regard to the life insurance policy, most banks will want to implement an indexed universal life ("IUL") policy because it offers the growth potential of an S&P 500 Index, with the downside protection to hedge against a down market. Most IUL contracts will have a floor of 1% (downside protection) but will cap the rate at about 12%. When looking back 25 years, most policies have achieved more than 7.7% in overall growth using this strategy.

As I review the premium financing strategy from start to finish—and assess its likelihood of success for a client or prospective client—I make sure to cover all potential risks, now or in the future. When advising any client or

potential client regarding life insurance matters and related issues, almost all corporations and individuals are comfortable taking on some level of risk due to the potential benefits.

In my earlier example, using the 58- and 60-year-old corporate males, there is simply no risk-free solution. If my client chooses to not insure them, risk is assumed because no funds will be available for the buy-sell agreement. For years, the individuals would purchase term insurance on each other—essentially acting as band aids—but there is still considerable risk because the individuals could certainly outlive the term of the contract.

When weighing the alternatives of paying premiums out-of-pocket vs. using a premium financing strategy, a few important issues arise. In a traditional payment schedule, there is "longevity risk", meaning if the client lives longer than anticipated, his or her internal rate of return ("IRR") decreases substantially. If the individual lives too long, the premium could exceed the death

benefit. Conversely, with a properly financed structure, the loan is typically going to be paid off upon the insured's death, so there must be an increasing death benefit each year. In other words, the longer the client lives, the greater the death benefit that should be made available to his or her beneficiaries.

Regardless of whether the client pays premiums out-of-pocket or finances the life insurance plan, performance risk should always be at the forefront of any decision. The rate of return ("ROR") inside the life insurance policy must perform at a reasonable pace. I have seen stress tests performed on these plans with RORs run well below the historical average, combined with an increased borrowing rate. I am comfortable with how the premium financing strategy plays out even with less than favorable economic conditions. From an overall or global perspective, it is difficult to envision many scenarios, even under the most grim economic conditions, where a premium finance structure will not have less out-of-pocket cost and leave more value to a beneficiary than an alternative structure using a traditional or out-of-pocket premium schedule.

In essence, the significant value that the premium financing strategy provides for my client is that it continues to retain corporate assets and allows such assets to appreciate, but at the same time my client is preparing for future buyout or other obligations in a financially sound and legally compliant manner. Based on my research and experience with the premium financing concept, I know that the strategy is largely advantageous for many clients who want to plan for future business needs and who have the needed assets to pledge as collateral for the related loan.

Final Thoughts

My role as legal counsel in a properly structured premium financing plan is only part of the equation. In some instances, I establish a new entity in conjunction with the premium financing to accomplish my client's specific objectives. In certain estate plans, I may recommend an irrevocable life insurance trust ("ILIT") when the goal is to hedge against a potential estate tax. Moreover, I am seeing an increasing use of COLI, including premium financed life insurance, to informally fund nonqualified deferred compensation plans for corporations and their key executives.

As part of the process, it is important to involve a life insurance professional and a bank who have considerable knowledge and experience with premium financing. Finally, I always make sure to carefully research the life insurance companies involved. There can be a significant difference in not only underwriting results, but how the policy projects and performs—and ultimately, how much is left to life insurance beneficiary.

About the Author

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An attorney at Fraser Stryker PC LLO, Emily R. Langdon focuses her practice on employee benefits and ERISA, assisting her clients with matters related to health and welfare benefits, executive compensation, pension and retirement plans, wellness plans, and health care reform.

Emily emphasizes effective communication and strategic planning when working on benefit plan design and compliance. She analyzes complex legal issues and state key points in a practical manner that can be applied to real-life client situations.

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