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Lending on the Security of Life Policies

A practical guide

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1. Introduction

In this briefing paper we set out the main issues for a lender to consider when taking a security interest in the life assurance policy of an UHNW. We have focused on "whole life" insurance policies since, for the reasons mentioned below, these will generally be the only type of policies suitable for a lender to use as collateral.

2. Review of the Policy

As obvious as it sounds, the first due diligence which a lender must carry out when considering whether to enter into this type of transaction with an UHNW borrower, is to review the life assurance policy documentation (the "**Policy**") itself.

There are basically two types of life insurance policy: term life insurance, which pays off only if the subject of the policy dies within the policy term and permanent ("whole life") insurance which involves a higher level of premium in the early years so that the premium stays level in the life assured's older and more high-risk years. What is "overpaid" in the early years is set aside and referred to as "cash value". In the first ten to fifteen years of the whole life policy, the insurance company is allowed to assess "surrender charges" to recoup its sales commission and related costs. The difference between the cash value and the surrender charges is known as the "surrender value". Generally this is the amount which can be borrowed against the policy and is known as the "loan value".

The Policy terms must be checked to ensure that the policyholder is entitled to assign his or her interest to a third party (such as the lender) and if there are any special provisions governing the method of assignment which would need to be followed by the parties.

The lender must also satisfy itself that it is comfortable with the Policy terms and in particular that the surrender value of the policy is of a sufficient amount to cover the liabilities which the lender requires to be secured, for example the amount being borrowed under the facility. The terms of the Policy will need to be examined to understand what payments and charges may be payable if for example the Policy is surrendered or encashed prior to the Policy's maturity date, as these may significantly reduce the "face value" of the Policy. Also, a lender will wish to check that the age of the life assured is admitted, that the Policy will not be avoided by the life assured's suicide and that the policy is not written in trust (see under 3 below). Another risk is that the Policy may be vitiated because the life assured has failed to disclose all material facts and circumstances to the insurance company whether innocently or not. Also, if the Policy is effected by a limited company, the lender should verify that it has an insurable interest in the life assured, because, if not, the lender will not be able to enforce payment of the policy moneys.

Life assurance policies may be issued by offshore insurance companies. Advice from local lawyers on the assignment provisions and other terms of the Policy is usually necessary as the governing law of the Policy will normally dictate the governing law of the security interest over the Policy.

The lender will also want to understand how the Policy is invested and whether there are any limitations or restrictions on encashment of those investments. Typically, the policyholder's recourse is to the life assurance company itself (rather than the underlying investments directly). The lender's credit decision should therefore consider both the investments and the Policy issuer. Statutory compensation schemes may be available in the event of a failure of the Policy issuer and local lawyers should be asked to advise on the impact, if any, of the lender taking security on the availability of any such compensation scheme.

3. Assignment/mortgage

The security created over the Policy can be legal or equitable, but in either case it is essential that notice is given to the insurance company to preserve priority and protect the effectiveness of the security. A legal assignment by way of security is the best form of security a lender can take over a Policy, as an equitable charge will rank behind any prior equitable interest, for example, beneficiaries under a trust. The assignee under a legal assignment giving value (e.g. making a loan) on the other hand without actual or constructive notice of a subsisting equitable interest will override it.

The assignment/mortgage document itself (the "**Assignment**") must be in writing and would normally be drafted by the lender's counsel based on its standard form of assignment. It will generally (but not always) be in the form of a deed. As mentioned above, the Assignment will normally be governed by the laws of the jurisdiction where the Policy is issued. For the purposes of this briefing paper, we are assuming that the Assignment is to be governed by English law.

To perfect a legal assignment, the lender should give written notice to the issuer of the Policy at its principal place of business, and obtain from it an acknowledgement (see below). The form of notice and acknowledgement to be delivered by the policyholder and issuer would normally be attached as appendices to the Assignment.

An English law Assignment which is securing the obligations of a borrower under a revolving facility would normally include a "tacking clause". The purpose and effect of such a clause is to enable the lender to secure further advances (or new loans) lent under the facility, under the Assignment and to ensure that such secured amounts rank in priority to any amounts subsequently lent by, and secured in favour of, another lender.

Where there is any "third party" element, i.e. where the Assignment is securing the liabilities of a party other than the policyholder or where the security is being granted in respect of a number of borrowers, it is advisable to add detailed non-release third party protection provisions similar to those found in a guarantee. The purpose of such provisions is to protect the lender by ensuring that the obligations of the assignor under the Assignment will remain in place despite any changes to the

underlying obligations of the principal debtor (or other borrowers) to the lender (for example if the principal debtor changes its constitution or the lender agrees to vary or waive certain terms of the facility letter / loan agreement) and also to ensure that the lender is entitled to pursue the principal debtor without any competition or interference from the assignor.

Unlike legal assignments taken for value and without notice of a prior equitable interest, an equitable charge will not defeat prior equitable interests. In the context of life policies, equitable interests frequently arise under section 11 of the Married Women's Property Act 1882 which applies a trust where a policy of assurance effected by a person on his or her own life is expressed to be for the benefit of his or her spouse and/or children. The Civil Partnerships Act 2004 extends section 11 to apply in an equivalent manner to any policy of assurance taken out by a civil partner on his or her own life and expressed to be for the benefit of his or her civil partner and/or his or her children. It is therefore important for a lender to ascertain whether or not the Policy is a "Married Women's Act policy" and also any contingencies subject to which the sum assured is payable.

4. Notice

This is simply a notice from the policyholder advising the insurer / policy issuer that he or she has created a security interest over the Policy which he or she holds with that insurer / policy issuer and setting out to the insurer the rights which the lender (as assignee) now holds in the Policy. Any requirement under the Policy terms relating to an assignment should be identified and precisely followed.

The rationale behind a lender requiring a notice to be served on the policy issuer are:

(a) in the case of a legal assignment, in order to give the assignee the right to sue at law in its own name;

(b) to bind the policy issuer and prevent it from paying out any monies to the assignor (borrower) or his or her personal representatives without the lender's consent; and

(c) to preserve priority against any interests subsequently created: the priority of security interests over *choses in action* such as life assurance policies are generally determined by the order in which the security interest is notified to the relevant third party (here the policy issuer).

The notice should include a clear description of the Policy (including its policy number) so that it can be identified by the issuer.

5. Acknowledgment

The acknowledgement is a confirmation from the policy issuer addressed to the lender that it has received the notice of Assignment from the policyholder. Depending on the terms of the Policy, it may be necessary to obtain the consent of the issuer to such Assignment.

The acknowledgement also serves to provide the lender with certain undertakings in respect of the Policy (as may be required under the terms of the Assignment). For example, by signing the acknowledgement the policy issuer may be required to confirm to the lender that:

(a) it has not received notice of any previous assignment of the Policy or of any other security interest in that Policy;

(b) the Policy is in full force and effect and that there are no premiums (or other sums) outstanding from the policyholder;

(c) it will provide the lender with copies of the valuation reports at the same time as it provides any such statements to the policyholder;

(d) it will not permit any withdrawal from or encashment of the Policy without the lender's prior written consent and the proceeds of any claims under the Policy will be paid directly to the lender;

(e) it will provide the lender with written notice of any changes to the terms and conditions of the Policy;

(f) it will give written notice of any non-payment of establishment fees, administration fees or other fees which may become due under the Policy; and

(g) it will not cancel, terminate or avoid the Policy without giving the lender prior written notice and, if applicable, the opportunity to remedy any breach of the terms of the Policy (for example to pay any fees due to the policy issuer).

Receipt by the lender of the signed acknowledgment from the issuer should be a condition precedent to lending any monies under the facility. In our experience, liaising with the issuer and getting their agreement as to the form of the notice and acknowledgment will often take time, and therefore contact should be made between the policyholder, lender, and the issuer as early on in the transaction as possible.

6. Registration

In the event that the assignor is an entity incorporated in England, the assignment of a Policy does require registration at the UK Companies Registry under section 859A of the Companies Act 2006, otherwise it is not registrable in the UK. If so incorporated, a search should be made against the assignor to ensure that (amongst other things) there are no previous assignments by way of security registered in respect of the same Policy.

7. Other Condition Precedent deliverables

In addition to the Assignment and the notice document duly executed by the policyholder / assignor and the acknowledgment and acceptance of such Assignment duly executed by the policy issuer, a lender will normally require the following additional items to be delivered as conditions precedent to the overarching facility:

(a) the original policy schedule / certificate and any charges schedule, issued by the policy issuer in respect of the Policy; and

(b) enforceability and capacity legal opinions (as applicable) from local counsel in the relevant jurisdictions for the governing law of the Assignment, the governing law of the Policy (if different) and the jurisdiction of the borrower.

The reason that a lender will require (a) above is that it requires possession of the Policy in order to have a first ranking legal mortgage and could lose priority if the lender were negligent in failing to obtain or retain physical possession of the Policy.

A lender should also consider whether it is appropriate for the events of default under the facility letter/loan agreement to include the death of the policyholder, otherwise the secured obligations may not be payable at the time the assured life dies. It should be unnecessary to make the Assignment expressly enforceable on the death of the assured life, since the proceeds under the Policy would be payable to the lender in any event.

Where the borrower is an individual, considerations relevant to **lending to individuals** should also be considered (e.g. under FSMA and the Consumer Credit Act 1974). Please refer to Fieldfisher's briefing paper on this topic.

For further advice please speak to either of the contacts below.

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