

By Karen Ostad, Chiahua Pan
and Kimberley Diamond

Bankruptcy's Breath of *Life*

The 2006 investigation by the attorney general of the state of New York into certain origination and sales practices of Coventry First brought securitizations of life settlement policies to a definitive halt. However, the recent sale under Section 363 of the Bankruptcy Code of a portfolio of policies initially pooled by Coventry may revitalize that market.

The complaint against Coventry alleged, among other things, that the firm had rigged the auction process for buying life settlement policies by offering compensation to other brokers to refrain from submitting higher bids. One remedy the New York attorney general proposed was to void Coventry's original purchase of the policies by allowing remedial rescission rights — effectively permitting each policy seller to determine whether to rescind the original sale to Coventry.

That posed an unacceptable risk for securitizations of such assets: it would undermine the stability and value of the collateral pool. At the time, two Ritchie Capital hedge funds were in the process of securitizing a number of pools backed by policies bought from Coventry. As a consequence, Moody's withdrew the investment-grade ratings it had assigned to senior tranches of the securitization and the hedge funds were forced to abort the planned securitizations. Subsequently, Ritchie Capital found the pools to be unmarketable. The resulting concerns proved sufficient to close down the small but developing life settlements securitization market completely. Ritchie Capital filed for Chapter 11 last June. But the 363 sale of the underlying life settlement policies this January may present the purchasers of the policies with another opportunity to securitize the assets. In a 363 sale, the debtor's assets are sold "free and clear of any interest in such property." As a consequence, creditor claims and liens relating to the debtors — the Ritchie hedge funds in this case — attach to sale proceeds but are extinguished against the assets being sold, assuming certain conditions are met.

Because potential rescission was a concern in the Ritchie case, the bankruptcy court ordered that the purchasers of the Ritchie policy pools would not be liable for any pre-existing

liabilities, claims, or rights of rescission, or causes of action as successors to the Ritchie assets — other than obligations that were expressly assumed, such as the obligation to continue to pay premiums on the underlying policies.

Moreover, to alleviate concerns about possible future claims, the bankruptcy court also held that good and sufficient notice had been provided to all interested parties — including policy sellers and regulatory authorities — and ruled that no parties would be permitted to start or continue any action or other proceeding, including asserting a right of rescission, against the purchasers of the assets. To avoid any doubt as to the scope of the order, the bankruptcy court explicitly stated that the order was binding on all parties, including administrative agencies, governmental departments, and federal and local officials. Although it remains to be seen whether the 363 sale order will indeed shield the purchasers from all future claims, the order certainly helps limit, if not altogether alleviates, most risks and facilitates efforts by purchasers to securitize the cleansed assets at the appropriate time.

As a result of the protections the order incorporates, the open 363 auction attracted six competitive bidders for the life settlement asset pools. The lender to Ritchie Capital with a lien on the policies in one pool bid its loan and became the owner of that pool, and the three other policy pools were sold to another purchaser. Proceeds from the asset sales will be used to satisfy creditors' claims against Ritchie Capital and monetary damages associated with a determination of any rights to rescission that the court may grant to claimants in the Coventry or other actions.

As the Coventry example illustrates, the threat of contract rescission and ratings withdrawal may have serious consequences for the original purchaser of a pool of life settlement policies. However, forward-looking purchasers may view the protections from prior claims that come with a 363 sale as a powerful tool by which to acquire such policies — or indeed other distressed assets.▼

The views expressed in this article represent the views of the authors, not necessarily the views of Morrison & Foerster or its clients.

Karen Ostad is a partner in the New York office of the Bankruptcy and Restructuring Group at Morrison & Foerster LLP, Chiahua Pan is partner specializing in the insurance industry, and Kimberley Diamond is an associate in the New York office of the firm.