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Sachin Kohli
University at Buffalo School of Law (Student)

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Pricing Death: Analyzing the Secondary Market for Life Insurance Policies and its Regulatory Environment

SACHIN KOHLI†

INTRODUCTION

Life insurance has traditionally been classified as an illiquid asset.[1] Unlike common stocks, which have, for

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† Editor-in-Chief, *Buffalo Law Review*, 2005-2006; JD/MBA Candidate, State University of New York at Buffalo, 2006; BS, Industrial Engineering, State University of New York at Buffalo, 2002. I would like to thank Ronald J. Yoviene, ChFC and Maurice L. Naylon III, ChFC, CLU both of The Financial Architects (http://www.financialarchitects-usa.com) for their tremendous assistance while writing this Comment, Professor David Westbrook for his guidance and comments on an earlier draft, and the staff of the *Buffalo Law Review* for their editorial assistance. Any errors, however, are my own. I would also like to thank my family and Pooja Gulati for their incredible support in all of my endeavors. © 2006 by Sachin Kohli.

1. Liquid assets are often considered to have at least one of the following two attributes.

> First, the instrument may be traded in a market with a sufficient number of participants to make feasible purchases and sales on short notice at prices near the contemporaneous equilibrium value of the instrument. Thus, common stocks actively traded on the New York Stock Exchange are considered more liquid than most municipal bonds. There exists an almost purely competitive market for the former securities, whereas secondary market sales of municipals often require substantial price discounts if they are to be completed quickly. Second, an asset is regarded as liquid if its equilibrium value is unlikely to change substantially over a given interval of time. Even though short-term municipals do not trade in an active secondary market, their values are not as volatile as those of common stock issues. A seller of a short-term municipal can therefore spend more time searching for a favorable trading partner without bearing excessive price risk during the search process.

Kenneth D. Garbade & William L. Silber, *Structural Organization of Secondary Markets: Clearing Frequency, Dealer Activity and Liquidity Risk*, 34 J. FIN. 577, 577 (1979).

example, the New York Stock Exchange (NYSE) and the NASDAQ as secondary markets, life insurance has not had a legitimate market where in-force policies could be bought and sold. To most policyholders, the value of life insurance rests in the security and certainty that it provides and not its liquidity; to many, purchasing life insurance is "the opposite of gambling."[2]

For many years, people treated life insurance as an illiquid asset because there was no secondary market that would allow policyholders to safely sell their policies.[3] Instead, the only options that existed for a policyholder were to either (1) keep the policy by continuing to pay the associated premiums or (2) allow the policy to lapse by surrendering it back to the life insurance company for a predetermined surrender value, which in some cases is zero.[4]

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2. Life insurance has long been used to preserve a family's economic security after the death of the family's income producer.

> From the family standpoint, life insurance is a necessary business proposition that may be expected of every person with dependents as a matter of course, just like any other necessary business transaction which ordinary decency requires him to meet... The family should be established and run on a sound business basis. It should be protected against needless bankruptcy. The death or disability of the head of this business should not involve its impairment or dissolution any more than the death of the head of a bank, railroad, or store.
>
> . . . Life insurance is a sure means of changing uncertainty into certainty and is the opposite of gambling. He who does not insure gambles with the greatest of all chances and, if he loses, makes those dearest to him pay the forfeit.

ESSENTIALS OF LIFE INSURANCE PRODUCTS, 1-19 to 1-20 (Burke A. Christensen & Glenn E. Stevick, Jr. eds., 2004).

3. *See infra* note 70.

4. *See* Neil A. Doherty & Hal J. Singer, *The Benefits of a Secondary Market for Life Insurance Policies*, 38 REAL PROP. PROB. & TR. J. 449, 450-51 (2003) (explaining that "[i]n the case of the lapse of a term-life policy, a policyholder who could no longer afford premium payments simply lost his insurance coverage and received nothing. In the case of a surrender of a universal, or whole-life policy, the predetermined schedule of surrender values offered by the insurance company—representing at most the reserve set aside to fund future insurance costs at standard rates—did not compensate a policyholder for the full actuarial value of the impaired policy.").

In recent years, however, the traditional understanding of life insurance—and its liquidity—has undergone change.[5] Older policyholders are now selling in-force life insurance policies to independent third parties (known as life settlement providers) in a secondary market transaction. The transaction of selling one's policy to a life settlement provider is referred to as either a viatical settlement or a life settlement. The only difference between the two terms is that viatical settlements deal with insured individuals who have a life expectancy of less than twenty-four months and life settlements deal with individuals who are expected to live more than twenty-four months.[6]

The fundamental aspects of a life settlement transaction are fairly simple. An elderly policyholder sells his life insurance policy to a life settlement provider (LSP) for an amount that is lower than the death benefit, but higher than the surrender value. After the sale, the individual that is insured by the policy remains the same, but the purchaser of the policy (or its designee) becomes the policy's new beneficiary. Upon the death of the insured person, the purchaser (or its designee) collects the death benefit from the policy. The following is an example that helps demonstrate the economics of a life settlement transaction. According to one life settlement provider's website, a sixty-eight-year-old policyholder who owned a $1 million universal life insurance policy with a surrender value of $2,128 was able to sell the policy to a LSP for $100,676.[7] That is almost fifty-times greater than what he would have received had he surrendered the policy back to the life insurance company. In return for purchasing the policy, the LSP will receive the $1 million death benefit upon the insured's death. From the LSP's perspective, a return on

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5. *See* M. Bryan Freeman, *Life Settlements Enter The Mainstream*, NAT'L UNDERWRITER LIFE & HEALTH, Sept. 19, 2005, at 20, 20 (discussing how "[t]he secondary market gives policies liquidity similar to that of more familiar tradable commodities, such as stocks, bonds and residential mortgages.").

6. GLORIA GRENING WOLK, VIATICAL & LIFE SETTLEMENTS: AN INVESTORS GUIDE 13 (2005). For legislative purposes, viatical settlements are treated the same as life settlements. *See infra* note 111. Industry participants, however, distinguish between viatical and life settlements because of the negative stigma surrounding viatical settlements. *See infra* Part III.A.

7. Maple Life Financial Offerings: Life Settlements, http://www.maplelifefinancial.com/LS/purchasing.asp (example #5) (last visited Feb. 26, 2006).

investment is guaranteed so long as it continues to maintain the policy and the life insurance company does not go out of business.[8] The LSP's rate of return, however, depends on the length of the insured's life.[9]

Part I of this Comment discusses the life settlement transaction: who is involved, how the process works, and why people are using life settlements. Part II discusses the emergence of the market in light of its troublesome history and analyzes its future potential given demographic trends in the United States. Part III discusses the regulatory landscape of the life settlement industry, analyzing model statutes developed by the National Association of Insurance Commissioners (NAIC) and the National Conference of Insurance Legislators (NCOIL). Part IV addresses certain deficiencies in these model statutes and recommends certain actions to help ensure the proper growth of the secondary market for life insurance.

I. UNDERSTANDING THE TRANSACTION, HOW THE PROCESS WORKS, AND WHY PEOPLE ARE USING LIFE SETTLEMENTS

A. *Who is Involved?*

The secondary market for life insurance involves several key players. Similar to other secondary markets (e.g., the market for real estate) these players include buyers, sellers, brokers, and investors that help fund the purchase of life insurance policies. Other role players include medical examiners, attorneys, and life insurance companies.

In its simplest form, a life settlement transaction is similar to any other purchase/sale transaction. That is, a willing buyer and a willing seller come together to negotiate the purchase/sale of a specific asset—in this case, a life insurance policy. In addition to negotiating the purchase/sale of the asset, both parties perform their due diligence in

8. Model regulations address the potential of life insurance carriers going out-of-business as a concern. *See* VIATICAL SETTLEMENTS MODEL ACT § 8(D)(4) (Nat'l Ass'n of Ins. Comm'rs 2004) (providing for a warning to investors that a life insurance company may go out of business); *see also infra* note 18.

9. *See, e.g., id.* § 8(D)(2) (providing for a warning to investors that their rate of return is dependent upon the length of the insured's life).

contemplation of the transaction. It is important to note, however, that the dynamics of a life settlement transaction are quite distinct. The sellers in a life settlement are, by default, older individuals. Furthermore, the value of the asset that is being sold is contingent upon someone's death.

1. *Sellers*. In a life settlement transaction, the seller must be the owner of the life insurance policy because the owner has control over the policy. The seller does not have to be the person who is insured by the policy. For example, in the case of company-owned life insurance (COLI), the owner of the policy is the company, but the insured individual is a company employee. With COLI and other similar arrangements,[10] the policyholder would have to be the seller in the transaction.[11] Furthermore, in order for the seller to be eligible for a life settlement, the insured individual and the policy must meet the buyer's requirements; each LSP has its own set of investment criteria.[12]

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10. In order to own life insurance on another party, you must have an insurable interest.

> An insurable interest can arise out of economic relationships, not only in debtor-creditor situations, but also in a number of other business contexts. The law generally recognizes the insurable interest of partners in each other's lives and health, of business enterprises in the lives and health of their officers and key employees, and of closely held corporations and their shareholders in the lives and health of shareholders whose death triggers a buy-sell arrangement. In some instances the rules are statutory; in others they derive from case law.

THE LAW OF LIFE AND HEALTH INSURANCE § 2.07 (2005).

11. *See* Tammy Chase & Leslie Griffy, *Gov Targets Business Tax Loopholes*, CHI. SUN-TIMES, Feb. 15, 2004, at 3 (discussing company-owned life insurance in light of recent criticisms of the tax loopholes it presents, but also illustrating the point that company-owned life insurance is truly owned by the company and that when the employee dies, the company receives the benefit.)

12. For example, life settlement provider, Coventry First, specifies that an ideal candidate for a life settlement is someone who is age sixty-five and over, owns a life insurance policy with a face amount of at least $250,000, and has a life expectancy of fifteen years or less. Coventry First, Candidates for a Life Settlement, http://www.coventryfirst.com/secondary-market/life-settlements/who-qualifies.asp (last visited Feb. 9, 2006). On the other hand, MapleLife Financial states that life settlement candidates are age fifty-five and older; have a life expectancy of greater than two years; own a transferable universal life, variable universal life, second-to-die, or term life insurance policy with rating of BBB+ or higher from Standard & Poor's; and own a policy with a face amount between $100,000 and $50 million. Maple Life Financial Offerings: Life Settlements, http://www.maplelifefinancial.com/LS/purchasing.asp (last visited Feb. 9, 2006).

Typically,[13] the established criteria to qualify for a life settlement are that the insured be at least sixty-five-years-old, have deteriorating health,[14] and have a life expectancy of less than fifteen years.[15] In addition, the life insurance policy should have a minimum face value of $100,000,[16] be past the two-year contestability period,[17] and be "issued by a life insurance company with an 'A' rating or higher."[18] A policyholder who meets these requirements may qualify as a seller in a life settlement transaction.

2. *Buyers*. The buyer in a life settlement transaction is commonly referred to as a life settlement provider. The LSP is an entity formed for the purpose of actively procuring life

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13. The criteria for establishing what policies qualify for a life settlement varies amongst the different life settlement providers. While they are all approximately the same, there are subtle differences amongst the providers such as the minimum required face value of the life insurance policy.

14. Deteriorating health does not mean being terminally-ill, which is typically defined as having a life expectancy of two years or less. Instead, deteriorating health means having slightly less than normal health. *See infra* notes 14 and 85.

15. Bill Tsotsos, *New Life Insurance Market: Life Settlements*, CALI. CPA, Mar.-Apr. 2004, at 25, 25.

16. *Id.*

17. *Id.* In general, after a life insurance policy has been in effect for the time period required by the incontestable clause,

> the insurance company cannot have the policy declared invalid. The courts have generally recognized three exceptions to this rule: (1) If there was no insurable interest at the inception of the policy, (2) if the policy had been purchased with the intent to murder the insured, or (3) if there had been a fraudulent impersonation of the insured by another person . . ., then the incontestable clause is deemed not to apply because the contract, which includes the incontestable clause, was void from its inception.

ESSENTIALS OF LIFE INSURANCE PRODUCTS, *supra* note 2, at 7-9. Furthermore, "[t]he laws of states differ as to the form of the clause prescribed, but no state permits a clause that would make the policy contestable for more than 2 years." *Id.*

18. *Id.* One of the risks, from an investors perspective, in a life settlement transaction is that the life insurance company will go bankrupt at some point in the future. It is important to note, however, that some LSPs do not require a life insurance company with an A rating. *See, e.g.*, *supra* note 12 (Maple Life Financial only requires a Standard and Poor's rating of BBB+ or higher).

insurance policies in life settlement transactions.[19] The LSP does most of the work in a typical life settlement transaction; LSPs are responsible for conducting the necessary due diligence on both the policy and the insured. For example, the LSP is responsible for evaluating the insured's medical records, determining the insured's life expectancy, and deriving a price for the life insurance policy.[20] LSPs can play two main roles in a transaction. First, they can coordinate transfers where they bring an investor and a seller together and the policy exchanges hands directly between the seller and the investor. Second, and more commonly, they can be more of an intermediary where they temporarily purchase the life insurance policy with the aim of reselling the policy to investors.[21]

3. *Brokers*. The broker is one of the key parties to a life settlement transaction. Most often, the policyholder's financial planner or life insurance agent will act as the broker in a life settlement transaction.[22] The broker's role is similar to that of a real estate broker—matching up buyers and sellers. Since the secondary market for life insurance is still relatively unknown amongst policyholders, financial planners and life insurance agents are usually the ones who suggest the life settlement option.[23] Life settlement brokers are responsible for being the liaison between the buyer (the LSP) and the seller (the policyholder). The life settlement broker typically guides the policyholder through the entire process.

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19. *See* EMMANUEL MODU, A.M. BEST, LIFE SETTLEMENT SECURITIZATION METHODOLOGY 3 (Sept. 1, 2005) *available at* http://www.ambest.com/debt/lifesettlement.pdf (last visited Feb. 9, 2006).

20. *See* Heather D. Mitchell, *The Producer's Role in a Life Settlement*, LIFE INS. SELLING, Feb. 2004, at 1, 2 (statement of Matthew H. Knepper) (discussing that life settlement providers do most of the legwork in the transaction).

21. *See* JEAN C. GORA, VIATICAL AND LIFE SETTLEMENTS: THE CHALLENGE FACING THE LIFE INSURANCE INDUSTRY 18-19 (2000).

22. *See* Mitchell, *supra* note 20, at 3 (statement of William Scott Page) (explaining that producers are important in assisting clients in obtaining records and acting as a liaison between the settlement provider and the client).

23. Since the life settlement market is still in its infancy, most seniors are unaware of the life settlement option; therefore, it is common that financial planners and agents will suggest life settlement options to their clients. *See id.* (explaining that the life settlement option can make the producer seem like a hero to their client "because they are taking a non-performing asset and turning it into a fantastic investment.").

4. *Investors.* In the real estate market, most buyers borrow money from lending institutions to fund the purchase of a real estate asset. In the secondary market for life insurance, LSPs typically find investors, borrow money, or utilize capital markets to finance the purchase of life insurance policies. Unlike the late 1990s, when viatical settlement providers received capital from individual investors,[24] LSPs are more commonly being funded by institutional investors.[25] Consequently, there has been less fraud in the life settlement market when compared to the viatical settlement market because institutional investors perform a much higher level of due diligence before making an investment.[26] Life settlements have evolved into an investment that is respected and utilized, in some form, by many Wall Street institutions including, among others, Merrill Lynch, Citibank, and UBS.[27]

5. *Role Players.* Other important parties who play a role in life settlement transactions include medical examiners, attorneys, and life insurance companies. Medical examiners are responsible for reviewing and evaluating the medical records and mortality profile of the insured individual.[28] Attorneys help review documentation to ensure compliance

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24. *See infra* text accompanying notes 79-83.

25. *See* Jim Connolly, *Institutions Reshape Life Settlement Market,* NAT'L UNDERWRITER LIFE & HEALTH, Sept. 20, 2004, at 14, 14.

26. *See* Ron Panko, *Cashing Out: Big Banks and Insurers are Putting Money Into the Business of Buying Unwanted Life Insurance Policies, a Trend That Foreshadows Growth for the Still-New Industry,* BEST'S REV., Apr. 1, 2002, at 92, 92 (referencing Coventry First CEO, Alan Buerger, who explains that the due diligence required by institutional investors serves as a "very strong anti-fraud program.").

27. *See* Harold G. Ingraham, Jr. & Sergio S. Salani, *Life Settlements as a Viable Option,* J. FIN. SERVICE PROF., Aug. 2004, at 72. The authors states that

> [i]nstitutions from around the globe have already participated in the life settlement industry in one way or another. Some of them include: 1) HVB FondsFinance (a unit of HypoVereinsbank), 2) Gen Re (a former unit of Berkshire Hathaway), 3) Merrill Lynch, 4) Lloyds of London, 5) C.N.A., 6) Zurich, 7) Abbey National, 8) DG Bank, 9) BVT, 10) Maple Financial, 11) AIG, 12) UBS, 13) Deutsche Bank, 14) Citibank, 15) GE Capital, 16) The Bank of New York, 17) Dresdner Bank and 18) U.S. Bank & Trust.

Id. at 75.

28. *See* MODU, *supra* note 19, at 3.

with state regulations.[29] And life insurance companies must be informed that the policy is being transferred to a different owner and the beneficiary is being changed.[30]

B. *How the Transaction Works*[31]

1. *Back-End.* There are two main transactions in the life settlement industry.[32] The first transaction, often referred to as the back-end transaction, involves the LSP and how it finances the purchase of life insurance policies. Initially, LSPs are often capitalized by institutional investors. In 2002, for example, a subsidiary of Warren Buffet's Berkshire Hathaway invested $400 million into a life settlement firm for the purpose of buying life insurance policies from seniors.[33] According to analysts involved with the secondary market, the life settlement "market is becoming 'totally institutionally funded . . . .'"[34]

Aside from having direct investors, LSPs have also utilized creative financing techniques to facilitate the purchase of life insurance policies. LSPs have started securitizing their life settlement portfolios.[35] In short, LSPs

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29. *See id.*

30. *Id.*

31. For purposes of this Comment, the term "life settlement transaction" will be synonymous with the term "front-end transaction."

32. *See* Legislative Proceedings of VIATICAL SETTLEMENTS MODEL REGULATION § 3 (Nat'l Ass'n of Ins. Comm'rs 2004) (the legislative proceedings discuss the need to "differentiate between the 'front end' of the transaction (the transaction between the viatical settlement provider and the viator) and the 'back end' of the transaction (the transaction between the viatical settlement provider and the investor).").

33. John Hoogesteger, *Berkshire Unit Lends $400M to Startup; Firm Buys Out Life Policies*, MINNEAPOLIS/ST. PAUL BUS. J., Feb 1, 2002, at 1, *available at* http://twincities.bizjournals.com/twincities/stories/2002/02/04/story1.html (last visited Feb. 26, 2006).

34. Connolly, *supra* note 25, at 14 (quoting Moritz Roever, an analyst with Scope Group, Berlin, a German fund rating agency).

35. For example, Duetsche Bank and Nomura Securities have been reported to have an interest and involvement in the securitization of life settlements. Furthermore, it has been reported that Merrill Lynch priced a $70 million offering by Legacy Benefits Corp. *See* Sarah Mulholland, *Deutsche Bank Builds Life Insurance Portfolio for Term Deal*, ASSET SECURITIZATION REPORT, Nov. 29, 2004, at 12; *see also* Press Release, Swiss Re, *Swiss Re Completes USD 245 Million Securitisation of In-force Life Insurance Policies* (Jan. 21, 2005),

pool together the in-force life insurance policies that they purchase and sell fractional interests to institutional investors. Collectively, these policies are expected to payout certain amounts of money over a certain period of time. And because there tends to be a large number of diverse policies in the pool, on average, the payout expectations hold true. Essentially, LSPs are reselling the life insurance policies that they have purchased. This resale of the life insurance policies replenishes a LSP's supply of capital, allowing it to continue purchasing more life insurance policies. The securitization of life settlement portfolios has become so popular that some financial institutions have funded LSPs with the intention of securitizing the final life settlement portfolio.[36]

2. *Front-End/Life Settlement Transaction.* The other main transaction in the life settlement industry, and the main focus of this Comment, is referred to as the front-end transaction or the life settlement transaction.[37] The front-end transaction involves the policyholder making a decision, usually with the guidance of a life settlement broker, to sell his policy. A life settlement transaction may be performed with virtually any type of life insurance policy including whole, term, universal, group, and variable life insurance policies.[38] In order for a life settlement to be completed with term/group life insurance policies, the policies must be convertible to some form of permanent /individual coverage. Term life insurance, by definition, only insures an individual for the risk of death during a certain period of his life (e.g., twenty years).[39] Therefore, if the insured individual outlives the specified term, his beneficiary will not receive any death benefit. In order for

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available at LEXIS, News Library, Prnewswire (discussing the recent successful $245 million securitization of a portfolio of life insurance policies generated by Swiss Re's life settlement unit, Admin Re. The securitization allows Swiss Re to more effectively use its capital according to CEO, John Coomber).

36. *See* MODU, *supra* note 19, at 1.

37. *See* Brian Brooks & Elizabeth Baird, *Clients May Hold Millions in Untapped Insurance Wealth, Study Finds*, ON WALL STREET, Nov. 2002, at 22, 23 (referring to the transaction "in which a life insurance policy is sold by the policyholder to a licensed settlement provider as the 'settlement' or 'front-end' transaction.").

38. *See* MODU, *supra* note 19, at 4-5.

39. *See* ESSENTIALS OF LIFE INSURANCE PRODUCTS, *supra* note 2, at 2-3.

LSPs to find value in such policies, the policies must be convertible to some form of permanent coverage so that a death benefit is guaranteed.[40]

Once a policyholder decides to sell his policy, the life settlement broker submits the life insurance policy to the handful of LSPs that are available, requesting quotes on how much they would pay for the life insurance policy given the insured's and the policy's profile.[41] After the LSPs perform their legal, financial, medical, and actuarial due diligence on the insured and the policy, and assuming the policy and insured meet the requirements, the LSPs submit an offer to purchase the policy. Upon receipt of all the offers, the policyholder and his broker will evaluate each offer tendered by the respective LSPs. In most circumstances, the policyholder will select the offer that provides the highest purchase price, but in certain circumstances that may not be the best option.[42] In addition to purchase price, the policyholder must take into consideration things such as the LSP's experience, capitalization, and reputation. After selecting a provider, the policyholder is paid the agreed upon amount and the policy is assigned to the LSP or its designee.[43] After the policyholder has accepted a life settlement offer, the policyholder no longer has any obligation to pay premiums on the life insurance policy because the owner and

40. *See* MODU, *supra* note 19, at 5.

41. *See* Carole Fiedler, *Get Smart with Life Settlements*, LIFE SETTLEMENT SALES RESOURCE, 2004 *available at* http://lifesettlementmag.com/articles.php?int_id=16 (discussing that shopping policies "to several qualified providers . . . . creates the most competitive bidding for the policy.").

42. According to one practitioner,

> [t]here have been cases where individually funded or smaller providers have made large settlement offers and may not necessarily have the funds at the time to back it up. When that happens, after the offer is accepted and contracts are signed, they start scrambling to get the money. Sometimes they even go to other settlement companies!

Id. Additionally, a benefit of individual investors over institutional investors is there added flexibility and they often take less time to close. *See id.*

43. To help facilitate the securitization/resale process, life settlement providers often use special purpose vehicles, bankruptcy remote vehicles, or trustees to hold the life insurance policy.

beneficiary of the policy is now the LSP.[44] The original policyholder assigns the policy to the LSP; therefore, it is the responsibility of the LSP to continue to pay the premiums in order to collect the death benefit when the insured dies.[45]

C. *Why Are Life Settlements Being Used?*

Prior to the secondary market for life insurance, if a policyholder could no longer afford or no longer wanted his life insurance policy, his only option was to either (1) let the policy lapse or (2) surrender the policy back to the life insurance company for either no value or a minimal surrender value.[46] Life insurance companies traditionally held monopsony power over policyholders because they were the only re-purchasers of in-force life insurance policies.[47]

1. *Market Value of the Life Insurance Policy may Exceed the Surrender Value.* For certain people, their life insurance policy may have a market value that exceeds the surrender value of the policy. Surrender values are calculated when a policy is originally written based on normal health assumptions.[48] Therefore, the surrender value represents what the life insurance policy is worth when the insured has normal health. A person's health, however, is hardly predictable and people often have less-than-normal health.[49] When an insured individual's health is impaired,

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44. *See* Arnold Machles & Ray S. Greenberg, *An Often Overlooked Asset*, PA. L. WKLY., Jan. 5, 2004 (explaining that "[a]ll rights and obligations of the policy may be transferred to a third party for a cash payment. All future premium payments are then the responsibility of that life insurance policy's new owner. Upon the insured's death, the benefits are payable to the new owner.").

45. *See id.*

46. One could have always sold his or her policy to a third party directly, but, as history has shown, that isn't the safest of endeavors. *See infra* note 70.

47. *See* Doherty & Singer, *supra* note 4, at 450 n.2 (explaining that the term 'monopsony' means a firm that controls the purchasing of a good or service in a given market).

48. *See* Neil A. Doherty & Hal J. Singer, *Regulating the Secondary Market for Life Insurance Policies*, 21-4 J. INS. REG. 63, 63 (2003).

49. Neil A. Doherty et al., *The Secondary Market for Life Insurance Policies: Uncovering Life Insurance's "Hidden" Value*, 6 MARQ. ELDER'S ADVISOR 95, 101-03 (2005).

the surrender value of the life insurance policy does not equal the policy's market value.[50] The reason for this is because a person with impaired health is more likely to die sooner than a person with normal health that age. Therefore, the death benefit is more likely to be paid out sooner compared to someone with normal health. From the policyholder's perspective, the policy is worth more than the surrender value because the insured is expected to die sooner. But from the insurance company's perspective, the policy is worth less because it will most likely have to pay the death benefit earlier than expected.

Here is an example to help illustrate: if an individual is sixty-five-years-old, in normal health, and is expected to die in ten years, the surrender value may accurately represent the market value of the policy because the insured is aging as expected; however, if the sixty-five-year-old's health is impaired and the insured is expected to die in five years, rather than the normal ten years, the market value of the policy is greater than the surrender value because the surrender value was pre-determined based on the assumption that the insured would live another ten years. Instead, now that the insured individual is only expected to live five more years, the death benefit will be received five years quicker than expected and the policyholder will only have to pay premiums for five more years rather than the anticipated ten years. There exists an opportunity for profit for those individuals who have life expectancies considered slightly less than normal based on the health assumptions used by insurance companies to develop surrender values.[51] Another factor at play is that many life insurance policies

50. From a technical perspective, a policy is considered to be impaired when

> [a]n individual's . . . life expectancy has decreased to a greater degree than expected at the issuance of the policy. For example, the IRS expects an individual who is 50 years old to live another 33.1 years and an individual who is 55 years old to live another 28.6 years Thus, conditional on his being alive in five years, a typical 50-year-old's life expectancy is expected to decline by 4.5 years over that period. If a 50-year-old's life expectancy did decline by roughly that amount, his health would be said to be normal, whereas if a deterioration in health caused the individual's life expectancy to decline by a larger amount—say 15 years—that individual would be said to have impaired health.

Doherty & Singer, *supra* note 48, at 64 n.1 (citation omitted).

51. *See id.*

were issued based on mortality tables that, at the time, were as correct as possible. Over time, however, these mortality tables have been refined to be more accurate.[52] The older mortality tables, which the surrender values of policies that are currently in-force are based on, may not accurately represent the true value of the life insurance policies. In short, life insurance companies are forced to predict the value of a life insurance policy in the future. LSPs, however, have the benefit of current, real-time information.

2. *Reasons why a Policyholder Would Consider a Sale in the Secondary Market.* There are a number of reasons why a policyholder would consider a life settlement and this Comment will address a few of them. The mere fact, however, that a policyholder may be eligible to sell his policy does not that mean selling the policy makes sense. Life settlements only make sense in certain circumstances. Typically, if a policyholder has the ability to continue paying the policy premiums, the policyholder should hold on to the life insurance allowing the beneficiary to collect the death benefit.[53]

The driving force behind selling a policy in the secondary market versus surrendering the policy or letting it lapse is money. For a life settlement to make sense, the net amount of money that would be received from a life settlement must be greater than the net amount of money received from surrendering the policy to the life insurance company. If that holds true, a sale in the secondary market may make sense for the policyholder. The circumstances that may prompt a sale in the secondary market vary greatly amongst the type of policies and sophistication of

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52. WOLK, *supra* note 6, at 107-31 (providing background on mortality tables and how they are created).

53. *See generally* DELOITTE CONSULTING LLP & UNIV. OF CONN., THE LIFE SETTLEMENT MARKET: AN ACTURIAL PERSPECTIVE ON CONSUMER ECONOMIC VALUE (2005), *available at* http://www.lifesettlementseducation.com/pdf/Life_Settlements_Mrkt_3.pdf (explaining that the intrinsic value of a life insurance policy always exceeds the value of a life settlement). *But see* Hal J. Singer & Eric Stallard, Reply to "THE LIFE SETTLEMENT MARKET: AN ACTURIAL PERSPECTIVE ON CONSUMER ECONOMIC VALUE" (Nov. 2005), *available at* http://www.criterioneconomics.com/docs/Reply_Deloitte_Final__ane.pdf (contesting the findings of the Deloitte Consulting and Univ. of Connecticut report).

policyholder. Here is a brief—but by no means exhaustive—list of situations in which a life settlement may be used:

- Life settlements are commonly used in conjunction with under-funded life insurance policies. In the 1990s, universal and variable life insurance were two of the most popular types of life insurance sold[54] on the premise that current premiums would be invested in the stock and bond markets, which in turn would fund the future premiums and make the policy self-sufficient. Unfortunately, with the decline of the stock market in the early 2000s, many of those expectations of self-sufficient life insurance policies never materialized and policyholders are now faced with large additional premiums that they did not plan for and cannot afford.[55] Life settlements have enabled people with underperforming life insurance to reclaim some of their policy's value, and to potentially reinvest in a better-suited life insurance policy.[56]
- Life settlements have been used to finance activities such as long-term care[57] and charitable gifts.[58]

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54. Approximately 34.3 million universal and variable life insurance policies were in force by the end of 2000. *See* Terry Savage, *The Stock Market Can Kill Your Life Insurance*, http://moneycentral.msn-ppe.com/content/Insurance/Insureyourlife/P35418.asp (last visited Mar. 14, 2006) (referencing the American Council of Life Insurance).

55. *See id.* (discussing the situation of one person who took out a variable policy in 1998 with a $3000 annual premium. With the stock market crash, the policyholder was faced with reallocating his investment decisions and paying premiums in excess of $8000 per year).

56. According to one practitioner's experience, two out of five life settlements resulted in the sale of another financial product. Mitchell, *supra* note 20, at 3 (statement of Scott Butterworth).

57. *See* Marielee Driscoll, *'Senior-Friendly' LTC Planning Includes Addressing the Underwriting Issues*, NAT'L UNDERWRITER LIFE & HEALTH, Apr. 29, 2002, at 17, 17 (explaining that a life settlement or viatical settlement is a top choice for financing long-term care); Paul J. Higgins, *Life Settlements Can Help Finance LTC Needs*, CAL. BROKER, June 2003, at 38, 38.

58. *See* Jolene D. Fullerton, *Using Life Settlements to Achieve Charitable Giving Goals*, NAT'L UNDERWRITER LIFE & HEALTH, Sept. 29, 2003, at 5, 5 (stating how the "owner of a life insurance policy can either sell the policy and give the proceeds of the life settlement to the charity or give the policy directly to the charitable organization that, in turn, immediately sells the policy for a lump sum of cash through a life settlement.").

- Life settlements are often used when seniors have outlived their beneficiaries or the original purpose for the life insurance is no longer present.[59] For example, many people who originally purchased life insurance as an estate planning mechanism may no longer have a need for those policies due to changes in estate tax laws.[60]
- In addition to individuals, many companies own life insurance.[61] These insurance policies may be held on "key-man"[62] individuals such as owners or they may be held on a group of employees constituting group life insurance. In certain instances, the life insurance policy may represent an asset that is no longer necessary to the company's success. Rather than surrender the policy for a minimum surrender value or perhaps

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59. *See* Steven Arenson & Robert G. Miller, *Consider Life Settlements as an Option for Divesting Life Policies*, NAT'L UNDERWRITER LIFE & HEALTH, July 7, 2003, at 8, 8 (listing some of the reasons a policyholder may no longer need his or her policy as: 1) a reduction in a client's estate size, or a change in tax policy, means the client requires less life insurance to pay projected estate taxes; 2) a client has a change in financial condition, and the premium is no longer affordable; 3) a client outlives his or her beneficiaries; 4) an increase in a client's liquidity makes life insurance a less desirable funding mechanism to pay estate taxes; and 5) a policy gifted to a not-for-profit organization can be sold by the organization to supplement current cash flow).

60. *See* Warren G. Whitaker, *Preparing for Changes in the Estate Tax*, N.Y. L.J., Jan. 24, 2005, at 12, 12 (explaining how the estate tax laws have changed and what potential changes may occur in the future).

61. Company-Owned Life Insurance has garnered much attention recently as Congressional Legislators argue that many companies are exploiting the opportunity to purchase life insurance for employees as a tax arbitrage strategy. *See Company-Owned Life Insurance: Hearing Before the S. Comm. on Finance*, 108th Cong. 65 (2003) (written statement of Gregory F. Jenner, Deputy Assistant Secretary, U.S. Department of Treasury).

62. Often times, lenders will require a small business to purchase life insurance on the business's primary operator. This mitigates the risk of the lender by ensuring payment of the debt with the proceeds of the life insurance policy if something were to happen to the "key-man." *See* Diane E. Lewis, *Minimizing Crisis's Impact: Contingency Plans Such as 'Key-Man Life Insurance' Can Help Firms Survive Disaster: Well-Planned Strategies Can Blunt Impact of Crisis on Firm*, BOSTON GLOBE, Oct. 14, 2001, at J1. To further emphasize that company-owned life insurance represents a significant opportunity for life settlements, a life settlement provider recently announced that it would create a new business unit to specifically buy company-owned life insurance policies. Fran Matso Lysiak, *Coventry First Forms New Business to Buy Existing Life Settlement and COLI Pools*, BESTWIRE, Dec. 17, 2004, *available at* LEXIS, News Library, BestWire.

no value at all, a company may now sell the policy in a life settlement transaction and reclaim some of its value.[63]

- Financially strained companies may find life settlements to be a viable option. For example, a company in bankruptcy may sell its life insurance policy to satisfy its creditors.[64] In an interview, Moe Naylon, a financial planner in Western NY, described a case that took almost two years to complete. The case involved a key-man policy owned by a corporation that was going through bankruptcy—the insured had an interest, the corporation had an interest, and a bank had a collateral interest. Once a life settlement offer was made, collateral interests and other considerations had to be addressed. The net result was the conversion of an asset with almost no cash value to over $300,000. A good deal of that money was used to fund pension deficiencies for those employees who were now out of work. All parties gained from this transaction. While Naylon was compensated well, he invested almost two years in a project that could have yielded no compensation.
- A solvent company may sell a life insurance policy to repay debt or buy-back stock from a shareholder.[65]
- Life settlement transactions may be used to facilitate the transfer of a business from one generation to the next or may be used to help finance an acquisition of another business.[66]
- Life insurance may be part of a company's assets to fund deferred compensation or other benefit programs that may have changed rendering them obsolete to the company.[67]

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63. *See* Valerie Greenberg, *Life Settlements: New Value in Old Policies*, MICH. B.J., Sept. 2003, at 32, 33 (discussing a situation where the assets of a business, including a key-man life insurance policy, were sold to another party who then chose to realize the value of the policy by selling it in a life settlement).

64. *See id.* at 32.

65. *See id.* at 34.

66. *See id.* at 33.

67. *See* Neil Alexander, *New Value in Old Policies*, J. ACCT., Oct. 2001, at 113, 114.

3. *Life Settlement Providers and their Investors.* The reason why LSPs, and those who invest in LSPs, are purchasing life insurance policies is because of the opportunity for profit and the characteristics of the investment. From the LSP's perspective, timing plays a critical role—the life expectancy of the insured drives the market price of the policy. In order for the transaction to make economic sense for the LSP, the present value of the death benefit must be greater than the sum of the life settlement price, the present value of the expected future premium payments, and the associated transaction costs.

Industry analysts have estimated that the expected return on a life settlement is nine to thirteen percent with an average holding period of seven to eight years,[68] but no one truly knows. LSPs are typically private companies so they have no obligation to report their financial results. A research report issued by Sanford C. Bernstein & Co. (the Bernstein Report) graphically shows the impact of life expectancy on an investor's rate of return. In the Bernstein Report's example, the internal rate of return on a life settlement ranges from 101% if the insured lives only two years to three percent if the insured lives eleven years.[69]

In addition, institutional investors are paying attention to the life settlement market because of the characteristics it holds as an investment. Unlike other investments, performance of a life settlement investment is "almost completely independent of the fluctuations in interest rates, inflation rates and other economic factors that drive returns on most other investments . . . ."[70] Therefore, investors have an opportunity to protect themselves from common risks associated with most of their investments.

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68. SANFORD C. BERNSTEIN & CO., LIFE INSURANCE LONG VIEW – LIFE SETTLEMENTS NEED NOT BE UNSETTLING 5 (2005) [hereinafter BERNSTEIN & CO.].

69. *Id.*

70. Connolly, *supra* note 25, at 14.

III. EMERGENCE OF THE MARKET

A. *Historical*

The secondary market for life insurance began in the early 1990s.[71] During that time period, terminally-ill individuals,[72] most often people living with AIDS,[73] sold their life insurance policies to third parties to finance medical procedures.[74] The transaction was named a viatical settlement.[75] Terminally-ill individuals praised viatical settlements because the sale of their life insurance policies allowed them to, in some instances, extend their lives and

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71. In theory, there has always been a secondary market because life insurance policies have been given the characteristics of property and individuals are free to contract with one another. In 1911, the Supreme Court held

> that the assignment by the insured of a perfectly valid [life insurance] policy to one not have any insurable interest but who paid a consideration therefor and afterwards paid the premiums thereon was valid and the assignee was entitled to the proceeds from the insurance company as against the heirs of the deceased.

Grigsby v. Russell, 222 U.S. 149, 149 (1911). Essentially, the Court's decision in *Grigsby* established the secondary market for life insurance policies; however, until recently, to sell ones policy was considered a risky endeavor. *See also* Allison Bell, *Life Settlement Firms Face Jumbled Regulatory Picture*, NAT'L UNDERWRITER LIFE & HEALTH, Sept. 20, 2004, at 40, 40 (discussing that in the 1700s, Englishmen sold their life insurance policies by auction. Unfortunately, they mysteriously wound up floating in the Thames River upon the sale of their policy).

72. To be classified as terminally-ill, the individual must have a life expectancy of less than two years.

73. *See* Michael Quint, *Pre-Death Cash: A Business Grows*, N.Y. TIMES, Nov. 14, 1998, at D1 (discussing that the viatical settlement market was mostly geared towards People living with AIDS but also included cancer patients close to death).

74. *See* Francis Flaherty, *Death Benefits Become Living Benefits*, N.Y. TIMES, Oct. 16, 1993, § 1 (Magazine), at 37 (discussing the use of viatical settlement proceeds to finance both medical expenses and day-to-day living condition expenses).

75. "The name viatical derives from the Latin viaticum--roughly translated meaning 'provisions for a long journey.' Industry pundits claim that the viaticum was a package of money or food given to Roman soldiers before embarking on a perilous campaign." Michael Cavendish, *Policing Terminal Illness Investing: How Florida Regulates Viatical Settlement Contracts*, FLA. B. J., Feb. 2000, at 10, 12.

fulfill life dreams.[76] Despite the benefits, the popularity of viatical settlements was short-lived. Fraud[77] and medical advances[78] quickly crippled the viatical settlements industry. For example, in 1997, it was uncovered that Personal Choice Opportunities (PCO), a viatical settlement business located in Palm Springs, was nothing more than an elaborate Ponzi scheme.[79] The owner of the business collected over $95 million from investors to purchase life insurance policies; however, none of that money was ever used to purchase life insurance policies.[80] Rather, new money from investors was used to pay old investors.[81] The owner of PCO pleaded guilty to cheating 1600 investors out of $95 million.[82] Unfortunately, this type of fraud was not uncommon in the viatical settlement industry in the 1990s.[83] Ultimately, the fraud-induced negative stigma[84] surrounding the viatical industry and medical advances in AIDS treatment prohibited the growth of the viatical settlement industry.

Putting the fraud associated with viatical settlements aside, the positive reaction from policyholders wanting to

76. One person living with AIDS used the proceeds from his viatical settlement to start a magazine entitled *Poz* for HIV-positive individuals. *See CBS This Morning: Viatical Insurance Settlements Allow Policyholders to Sell Their Life Insurance Policies before Death* (CBS television broadcast May 10, 1995), transcript *available at* LEXIS, News Library, CBSNEWS File.

77. According to state securities regulators in 1999, viatical settlements were one of the "ten most common investment scams . . . ." *Investment Fraud*, ST. LOUIS DISPATCH, May 25, 1999, at C12. *See also An Official Says Industry Can Police Policy-Buying*, N.Y. TIMES, Nov. 14, 1994, at D2; Robin Estrin, *Watchdog Condemns AIDS Insurance Scam*, CAP. TIMES, Aug. 20, 1992, at 1C.

78. *See* Carl T. Hall, *Viatical Firm's Stock Hit Hard*, S.F. CHRON., July 18, 1996, at C1 (discussing the impact of medical advances on a viatical settlement firms ability to procure life insurance policies from people living with AIDS and continue its business strategy).

79. WOLK, *supra* note 6, at 83.

80. *California Man Admits to Viatical Fraud*, L.A. TIMES, Nov. 14, 1997, at D2.

81. WOLK, *supra* note 6, at 83.

82. *Id.*

83. *See id.* at 84.

84. *See Investing in Death: Insurance Traders Gamble on Mortality of Terminally Ill*, CHARLESTON GAZETTE, Apr. 24, 1994, at 12A (discussing the "morbid world of viatical settlements").

sell their policies foreshadowed the potential for a secondary market for life insurance. Secondary market participants have recognized this demand and have shifted their resources away from tainted viatical settlements in favor of life settlements.[85]

B. *Where the Market is Headed*

The life settlement market is currently in its early stages of development. Demographic trends within the United States indicate that the market is positioned for tremendous growth. According to the Bernstein Report, one of the main drivers of future growth is that people in the U.S. are living longer;[86] therefore, people may outlive the usefulness and/or purpose of their life insurance.[87] Furthermore, the Bernstein Report estimates that "[t]he target market for life settlements . . . should grow 3x faster than the total population over the next 25 years . . . ."[88]

Currently, over 32 million baby boomers are over fifty-years-old and by 2030, the baby boomers will be ages sixty-six to eighty-four comprising approximately twenty percent of the U.S. population.[89] In general, baby boomers are considered to be unprepared for retirement.[90] Studies have

85. Life Settlements focus on individuals who are age sixty-five and over and have slightly impaired health. According to the Doug Head, an executive at the Viatical and Life Settlement Association of America, slightly impaired health means "a little sick" or "won't live to full life expectancy." *See* Jane Bryant Quinn, *Life Settlements Not Easy Money For Seller or Buyer*, S. FL. SUN-SENTINEL, May 15, 2001, at 3D.

86. For an illustration of how estimated life expectancy has increased over time, see Elizabeth Arias, *United States Life Tables, 2002*, NAT'L VITAL STATISTICS REP., Nov. 10, 2004, at t.12 *available at* http://www.cdc.gov/nchs/data/nvsr/nvsr53/nvsr53_06.pdf.

87. *See* BERNSTEIN & CO., *supra* note 68, at 2.

88. *Id.* at 6.

89. *See* METLIFE MATURE MARKET INSTITUTE, DEMOGRAPHIC PROFILE: AMERICAN BABY BOOMERS (2003), http://www.metlife.com/WPSAssets/19506845461045242298V1FBoomer%20Profile%202003.pdf (last visited Feb. 26, 2005).

90. "Experts say the failure to build a nest egg will come to haunt the baby boomers, forcing them to suffer drastically lower standards of living in their later years or to work longer, perhaps into their 70s." Bernard Wysocki Jr., *Binge Buyers: Many Baby Boomers Save Little, May Run Into Trouble Later On*, WALL ST. J., Jun. 5, 1995, at A1.

shown that baby boomers lack basic financial acumen[91] and experts predict that the financial future for baby boomers may be worse if Social Security benefits are cut or taxes are increased.[92] A report issued by the Congressional Budget Office found that "many baby boomers are likely to depend heavily on government benefits for the bulk of their income in retirement . . . ."[93] Life settlements may become an attractive option to help finance retirement for aging baby boomers given their retirement planning habits[94] and affinity for living well.[95] Furthermore, with uncertainty surrounding the future of Social Security and the increasing need for long-term care,[96] life insurance may no longer be considered a critical asset to baby boomers.

Another source of growth may come from term life insurance policies. Term policies, assuming they are convertible to some form of permanent coverage, are prime candidates for life settlements because often times the life

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91. *See, e.g.*, *Study: Boomers 'Paralyzed' Over Retirement Savings*, BestWire, Nov. 30, 2004, *available at* LEXIS, News Library, BestWre (discussing how some baby boomers do not understand simple financial concepts such as compound interest and adequate returns).

92. *See* Wysocki, *supra* note 90, at A1.

93. CONGRESSIONAL BUDGET OFFICE, BABY BOOMERS' RETIREMENT PROSPECTS: AN OVERVIEW 2 (Nov. 2003), http://www.cbo.gov/ftpdocs/48xx/doc4863/11-26-BabyBoomers.pdf (last visited Feb. 26, 2005).

94. Psychologists have studied where baby boomers have developed their saving habits.

> Prof. Charles Schewe of the University of Massachusetts says the boomers' values were formed during the prosperous 1950s and 1960s. This sense of material abundance may well remain with them as they age, even if the gap between perception and reality grows. Moreover, boomers can look across the generational divide, see many of today's 70-year-olds living well and simply assume that they will, too.

Wysocki, *supra* note 90, at A6.

95. It has been found that older baby boomers spend on average twenty-three percent more on hotels and vacation homes and twenty percent more on life insurance and other personal insurances when compared to other generations. *See* METLIFE, *supra* note 89.

96. *See Americans underestimate cost, potential need for long-term care, survey finds*, ELDER LAW WEEKLY, Feb. 9, 2005, at 8 (discussing how "only one-quarter of U.S. adults believe they are likely to need long-term care, despite predictions from independent organizations that half of the American population is likely to need some form of this specialized and potentially costly health care service.").

insurance contract[97] or state regulations[98] will restrict the age to which you may hold the policy. The policy, if allowed by the terms of the life insurance contract, must be converted to form of permanent coverage, such as whole or universal insurance.[99] Conversion of term policies represents an enormous opportunity for LSPs and policyholders[100] because term life insurance is one of the most popular forms of life insurance.[101] Ron Yoviene, a financial planner in Western NY, assisted a dairy farmer with a life settlement for term life insurance. The dairy farmer was seventy years old and could not afford the cost of converting to permanent insurance. Before Yoviene got involved, it appeared that the term would simply expire with no residual value to the insured. Instead, the insured received over $150,000 through a life settlement.

Consulting firms, economists, and life insurance organizations have all studied the life settlement market. One industry report estimates that there are approximately $500 billion worth of life policies owned by seniors, $100

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97. Life insurance "companies generally do not permit renewals to carry the coverage beyond a specified age such as 65, 70, or 75 (although some insurers guarantee renewability to age 95 or 99)." ESSENTIALS OF LIFE INSURANCE PRODUCTS, *supra* note 2, at 2-5.

98. For example, in New York State a policyholder that pays their own premiums may not hold term life insurance once the insured reaches the age of 80. *See* N.Y. COMP. CODES R. & REGS. tit. 11, § 42.4 (2004).

99. *See* Philip Lian & Evan Soldinger, *Converting a Term Policy for a Life Settlement*, BROKER WORLD, July 2003, at 20, 22 (discussing that not all term policies are convertible. "Some [term policies] don't permit conversion and clearly state so within the contract.").

100. For example, one article discusses a sixty-year-year-old male who was given a $5 million term life insurance policy as part of his employment arrangement. Upon retirement, the insured was able to convert the policy to universal life insurance and sell the policy to a life settlement provider for just over $1.9 million. *See id.* Clearly, this shows the success that can be obtained when converting a term life insurance policy to permanent coverage for a life settlement.

101. In 2003, the face amount of term policies purchased was over $1.2 trillion compared to $516 billion in whole and endowment policies. *See* AMERICAN COUNCIL OF LIFE INSURERS, 2004 LIFE INSURERS FACT BOOK 85 (2004), *available at* http://www.acli.com/NR/rdonlyres/ew3myygzuktyyje26x23kkzjjscb dwjoftpqvhp73xw27lgvbtll7qam3mvgab6enjhyuouz5jf6ap/fball.pdf [hereinafter ACLI 2004 Fact Book].

billion of which are eligible for life settlements.[102] Furthermore, another industry report predicts that $10 to $15 billion worth of life policies will be procured by LSPs in 2005 alone.[103] A German fund rating agency predicted that the total life settlement deal volume in 2004 would range from $6 to $8 billion and would grow to $15 billion in 2010.[104] All of the estimates indicate that the life settlement market is evolving into a formidable marketplace that is poised for growth. To further prove the secondary market's legitimacy, a leading LSP recently announced that it has accumulated over $2 billion in life insurance policies and that it *optimistically* expects the secondary market to surpass $45 billion by 2007.[105]

While LSPs[106] and life insurance companies[107] have sponsored studies to understand the effects and potential of a secondary market for life insurance, both the effects and potential can be understood by looking at historical and demographic trends. Since 1993, in-force life insurance has grown at an annual rate of four percent, totaling over $9 trillion in 2003.[108] Additionally, by including group and credit life policies, the total amount of life insurance in force in 2003 was slightly over $16 trillion, a 4.2% increase

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102. *See* Doherty & Singer, *supra* note 4, at 452-53 (citing a study released by industry researcher Conning & Co.).

103. *See* MAPLELIFE FINANCIAL INC., 2005 LIFE SETTLEMENT INDUSTRY OUTLOOK 4 (2005) *available at* http://www.maplelifefinancial.com/News/downloads/news_05OUTLOOK.pdf. MapleLife Financial prepared this industry outlook because of the lack of available information. The study was completed by sending out two surveys to a "diverse group of life settlement brokers, producers, accountants, attorneys, estate planners, financial planners, and charitable organizations." *Id.* at 1.

104. Connolly, *supra* note 25.

105. *See* Press Release, Coventry First, The Secondary Market for Life Insurance Expanding Rapidly; Coventry First Tops $2 Billion in Life Insurance Policies Acquired (Mar. 10, 2004) *available at* LEXIS, News Library, Prnewswire.

106. It is important to note that the industry benchmark economic study, conducted by Neil A. Doherty & Hal J. Singer, was sponsored by a life settlement provider. *See* Doherty & Singer, *supra* note 4, at 449 n.**. For another LSP-sponsored study, see MAPLELIFE FINANCIAL, *supra* note 103, at 1.

107. *See* DELOITTE CONSULTING LLP & UNIV. OF CONN., *supra* note 53, at 1 (disclosing that the study was paid for by a group of insurance companies, including Massachusetts Mutual Life Insurance Company).

108. ACLI 2004 FACT BOOK, *supra* note 101 at 83.

compared to 1993.[109] Over the past twenty years, the total amount of life insurance in force in the United States has grown steadily from under $5 trillion to just over $16 trillion.[110] Furthermore, the average face amount of individual life policies purchased has increased from approximately $40,000 in 1983 to approximately $130,000 in 2003.[111]

These statistics and growth trends reinforce the point that life insurance has become a common form of financial planning for many Americans. Furthermore, the demographic characteristics of the baby boomer generation lend support to the argument that the secondary market for life insurance is poised for future growth. The upside potential of the life settlement market is clearly significant. According to financial planners Moe Naylon and Ron Yoviene, however, there is little regulation in the life settlement area and the opportunity exists to take advantage of the public. For the ethical practitioner, however, who is in tune with the national network of competent brokers and funders, life settlements are one more tool to use in assisting a client with his or her overall financial planning.

IV. EXISTING REGULATORY RESPONSE[112]

The current legal environment surrounding life settlements is in a general state of flux. According to one industry professional, "regulations differ from state to state and . . . in some states they change from day to day."[113] As of April 2006, twenty-seven states regulate life settlement

109. *Id.* at 82.

110. *Id.* at 83.

111. *Id.* at 84 (figure 7.2 shows a graphical representation of the growth in the average face amount of individual life insurance policies purchased from 1983 to 2003).

112. It is important to note that a majority of lawmakers have treated both viatical and life settlements the same for legislative purposes. Most classify the settlement transaction, irrespective of whether it is a life settlement or a viatical settlement, as a "viatical settlement." Therefore, it is important to keep in mind while reading this section that viatical settlement and life settlement are, for legislative purposes, synonymous.

113. Bell, *supra* note 71, at 40 (quoting Douglas Head, the executive director of the Viatical and Life Settlement Association of America).

transactions[114] and twenty-three states and the District of Columbia do not regulate life settlements.[115] These statistics are sure to change, hopefully reaching some type of uniformity amongst all of the states.[116]

Most states have modeled their legislation after the National Association of Insurance Commissioners'[117] Viatical Settlements Model Act (NAIC Model Act). The NAIC Model Act was first adopted in 1993 to address the viatical settlement industry's growth in response to the AIDS epidemic.[118] The original NAIC Model Act did not address life settlements until December 2000, when the NAIC expanded the definition of "viator" to include individuals who are not terminally-ill, thereby including life

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114. Those states that regulate life settlements are as follows: Alaska, Arkansas, Colorado, Connecticut, Florida, Georgia, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Mississippi, Montana, Nebraska, Nevada, New Jersey, North Carolina, North Dakota, Ohio, Oklahoma, Pennsylvania, Tennessee, Texas, Utah, and Virginia.

115. Those states that do not regulate life settlements are as follows: Alabama, Arizona, California, Delaware, Hawaii, Idaho, Illinois, Massachusetts, Michigan, Minnesota, Missouri, New Hampshire, New Mexico, New York, Oregon, Rhode Island, South Carolina, South Dakota, Vermont, Washington, West Virginia, Wisconsin, and Wyoming.

116. Senator Michael Oxley is currently developing the "SMART" Act, which is labeled as a roadmap to insurance regulatory reform. Included in the SMART Act is a section on viatical settlements. Currently, as the SMART Act stands in draft form, all states would have within 3 years of the enactment of the SMART Act to adopt the NAIC's 2001 Viatical Settlements Model Act or laws that address the same consumer protection issues. Furthermore, the States will implement uniform or reciprocal laws governing the licensure of producers authorized to deal with viaticals. Finally, the SMART Act preempts any state that does not enact the NAIC Model Act or laws similar, by mandating that the NAIC Model Act governs in that jurisdiction. *See* Meg Fletcher, *Congress Takes a Closer Look at Overhauling Insurance Regs*, BUS. INS., Aug. 30, 2004, at 1, 1 (stating generally that the SMART Act, as currently drafted, will address viatical settlements).

117. "The National Association of Insurance Commissioners (NAIC) is the organization of insurance regulators from the 50 states, the District of Columbia and the four U.S. territories. The NAIC provides a forum for the development of uniform policy when uniformity is appropriate." About the NAIC, http://www.naic.org/about/background.htm. (last visited Feb. 26, 2006).

118. *See NAIC Update*, INS. REGULATOR, Sept. 27, 1993, at 7; Miriam R. Albert, *The Future of Death Futures: Why Viatical Settlements Must Be Classified as Securities*, 19 PACE L. REV. 345, 366 nn.62-63 (1998-1999).

settlements within the scope of the Act.[119] In addition to the NAIC Model Act, the NAIC has adopted model regulations (NAIC Model Regulations) that govern both viatical and life settlement transactions.

Alternatively, the National Conference of Insurance Legislators[120] (NCOIL) has adopted a model act known as the Life Settlements Model Act (NCOIL Model Act), which regulates both viatical and life settlement transactions. Both the NAIC Model Act and the NCOIL Model Act "seek to protect sellers of insurance policies . . . by ensuring that purchasers refrain from unfair practices or taking advantage of a [seller's] vulnerability, and do very little to protect the companies or individuals that purchase the policies and the investors that fund the purchase of the policies."[121] Although both the NCOIL Model Act and the NAIC Model Act have similar objectives, the respective model acts differ on certain substantive issues that this Comment will address.

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119. *See* Jessica Maria Perez, Comment, *You Can Bet Your Life on It! Regulating Senior Settlements to Be a Financial Alternative for the Elderly*, 10 ELDER L.J. 425, 439 (2002).

120. "The National Conference of Insurance Legislators (NCOIL) is an organization of state legislators whose main area of public policy concern is insurance legislation and regulation. Many legislators active in NCOIL either chair or are members of the committees responsible for insurance legislation in their respective state houses across the country." The National Conference of Insurance Legislators, http://www.ncoil.org/home.html. (last visited Feb. 20, 2006). As of February 2005, NCOIL is made up of the following member states: Alabama, Alaska, Arkansas, California, Connecticut, Florida, Georgia, Hawaii, Illinois, Iowa, Kansas, Kentucky, Louisiana, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Hampshire, New Jersey, New Mexico, New York, North Carolina, North Dakota, Ohio, Oklahoma, Pennsylvania, Rhode Island, South Carolina, Texas, Vermont, Virginia, West Virginia, and Wisconsin.

121. Ffiona M. Jones, Comment, *The Viatical Settlement Industry: The Regulation Scheme and its Implications for the Future of the Industry*, 6 CONN. INS. L.J. 477, 486 (1999-2000) (citing Jennifer Berner, *Beating The Grim Reaper, Or Just Confusing Him? Examining the Harmful Effects of Viatical Settlement Regulation*, 27 J. MARSHALL L. REV. 581, 587 (1994); and Alexander D. Eremia, *Viatical Settlement and Accelerated Death Benefit Law: Helping Terminal, But Not Chronically Ill Patients*, 1 DEPAUL J. HEALTH CARE L. 773, 779 (1997)).

A. *NAIC Model Act and Model Regulations Overview*

The NAIC Model Act and Model Regulations mainly focus on protecting the seller in a life settlement transaction by enacting disclosure and pricing requirements.[122] The NAIC Model Act calls for settlements to be governed by the law of the state in which the policyholder resides.[123] The laws under which the settlement contract is governed is important because the disclosure statement and settlement contract forms used in the transaction must be approved and filed with that state's insurance commissioner.[124]

In June 2004, the NAIC amended the license requirements under the NAIC Model Regulations to allow individuals licensed as an insurance producer with a life insurance company of authority for at least one year to act as settlement brokers with no additional training or licensing requirements.[125] The June 2004 amendment represented a significant departure from the NAIC's previous position requiring a separate licensing requirement for settlement brokers.[126] Organizations such as the American Council of Life Insurers and the National Association of Insurance and Financial Advisors have criticized this amendment, claiming that a life settlement transaction is different from selling life insurance; therefore, brokers need to be educated about the intricacies of the life settlement industry and they should have the appropriate credentials to engage in the business.[127] In a

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122. *See id.*

123. If there is more than one policyholder the laws of the state in which the policyholder having the largest percentage governs and if the percentage of ownership is equal, the mutually agreed upon jurisdiction by the policyholders will govern. VIATICAL SETTLEMENTS MODEL ACT § 3(A)(1) (Nat'l Ass'n of Ins. Comm'rs 2004)

124. *See id.* § 5.

125. *See* VIATICAL SETTLEMENTS MODEL REGULATION § 3(H) (Nat'l Ass'n of Ins. Comm'rs 2004).

126. *See* Jim Connolly, *NAIC Viatical Model Passes Without Licensing Requirement*, NAT'L UNDERWRITER LIFE & HEALTH, June 21, 2004, at 10 (discussing how the NAIC Model Act passed with the "[r]emoval of a provision in the model requiring a separate license for producers who recommend or sell viatical settlements . . . .").

127. *See* Bell, *supra* note 71, at 40, 42.

letter to the Chair of the NAIC committee overseeing the amendment to the NAIC Model Regulation, the Vice-President of Government Affairs for Prudential Financial urged the committee not to weaken the licensing requirements citing that it would be "contrary not only to good public policy, but common sense."[128] Prudential argued that

> [i]t is the broker who must explain the transaction to the policyholder and conform his or her conduct to the standards specifically established in the Model Act and Regulation. Without additional training and testing of competence and understanding of [life settlement] laws and regulations, a . . . settlement broker will not have demonstrated knowledge necessary to transact this business in a competent, legal and ethical manner.[129]

Alternatively, LSPs have applauded the recent change in the NAIC Model Act. Life settlement providers view it as a pro-secondary market move by the NAIC because it significantly increases the number of brokers who can present life settlements as an option to clients.[130]

The NAIC Model Act and Model Regulations also address privacy concerns for the insured. The Act prevents revealing the identity of the insured in most instances unless they give prior written consent.[131] In a drafting note, the NAIC mentions that the privacy language must be "broad enough to allow licensed entities to notify commissioners of unlicensed activity and for insurers to make necessary disclosures . . . ."[132] The Act also requires settlement providers to retain virtually all records pertaining to settlement transactions for at least five years and

128. Letter from George T. Coleman, Vice President of Government Affairs, Prudential Insurance Company of America, to Honorable Theresa Vaughan, Chair of NAIC Life Insurance and Annuity Committee (Feb. 13, 2004) (on file with the Buffalo Law Review).

129. *Id.*

130. *See* Press Release, Coventry First, NAIC Overwhelmingly Adopts Model Regulation on Life Settlements (June 17, 2004), http://www.coventryfirst.com/pdfs/pr6.17.04.pdf.

131. *See* VIATICAL SETTLEMENTS MODEL ACT § 6 (Nat'l Ass'n of Ins. Comm'rs 2004).

132. *Id.*

subjects them to the possibility of an inquiry by examiners appointed by the state insurance commissioner.[133]

The NAIC Model Act also focuses on disclosure requirements in settlement transactions. The Act mandates certain disclosures to the policyholder in the front-end transaction and to the investor in the back-end transaction. With respect to policyholders, the NAIC Model Act requires that the settlement broker or settlement provider disclose, among other things, that: (1) there are alternatives to settlements including accelerated death benefits[134] and/or policy loans,[135] (2) the proceeds of the settlement may be taxable,[136] (3) there is a fifteen day window in which the seller may rescind the settlement contract and if the insured dies within the fifteen days, the contract is automatically rescinded,[137] (4) funds will be sent within three business days after the settlement provider has received notice from the insurer that ownership has been transferred,[138] (5) they may be contacted by the settlement provider or settlement broker to see if they are alive, however, if their life expectancy is over one year, the contact will be limited to no more than once every three months,[139] and (6) how the settlement brokers commission is calculated and the amount they will receive in connection with the settlement of the policy.[140]

In the back-end transaction, the NAIC Model Act requires, among other things, that the following be disclosed: (1) there will be no return until the insured dies,[141] (2) the rate of return cannot be guaranteed and is

133. *See id.* § 7(B).

134. "Although ordinarily reserved for the survivors of the insured, life insurance benefits are often needed by the policyholder to finance current needs. When such benefits are distributed directly by an insurance carrier, they are called Accelerated Death Benefits (ADBs)." Eremia, *supra* note 121, at 774.

135. VIATICAL SETTLEMENTS MODEL ACT § 8(A)(1) (Nat'l Ass'n of Ins. Comm'rs 2004).

136. *Id.* § 8(A)(2).

137. *Id.* § 8(A)(5).

138. *Id.* § 8(A)(6).

139. *Id.* § 8(A)(10).

140. *Id.* § 8(B)(3).

141. *Id.* § 8(D)(1).

dependent upon how long the insured lives,[142] (3) the asset should not be considered liquid because there is no established secondary market for resale,[143] (4) the insurance company could go bankrupt,[144] (5) certain risks are associated with policy contestability,[145] and (6) if the insured lives longer than their projected life span, the investor may need to fund future premium payments depending on how the contract was structured.[146] Additionally, the NAIC Model Act allows the viatical settlement purchase agreement to be voided at any time by the purchaser within 3 days after they have received the mandatory disclosures.[147]

Finally, and perhaps the most important feature of the NAIC Model Regulation, is the minimum pricing requirements in Alternative 1 of Section 5. The regulations implement a price minimum by requiring that the seller be paid at least a certain percentage of the face value of the life policy less any outstanding loans.[148] The minimum price is broken down by the insured's life expectancy as follows:

- anyone who is expected to live less than six months must receive at least eighty percent of the face value minus any outstanding loans;
- anyone who is expected to live at least six months but less than twelve months must receive at least seventy percent of the face value minus any outstanding loans;
- anyone who is expected to live at least twelve months but less than eighteen months must receive at least sixty-five percent of the face value minus any outstanding loans;

142. *Id.* § 8(D)(2).

143. *Id.* § 8(D)(3).

144. *Id.* § 8(D)(4).

145. *Id.* § 8(D)(11) (explaining "that the purchaser will have no claim or only a partial claim to death benefits should the insurer rescind the policy within the contestability period."); *see also supra* note 17.

146. *Id.* § 8(D)(6).

147. *Id.* § 8(F).

148. *See* VIATICAL SETTLEMENTS MODEL REGULATION § 5 (Nat'l Ass'n of Ins. Comm'rs 2004).

- anyone expected to live at least eighteen months but less than twenty-five months must receive at least sixty percent of the face value minus any outstanding loans;
- and anyone who is expected to live longer than twenty-five months must receive at least the greater of the surrender value or accelerated death benefit in the policy.[149]

The current pricing regulations represent a departure from the past in which the NAIC required anyone who was expected to live longer than twenty-five months to receive at least fifty percent of the face value minus any outstanding loans.[150] An in-depth economic study, however, revealed that an absolute price floor would prohibit transactions worth approximately $119 million per year from taking place.[151] Proponents of the regulations argue that the imposed pricing scheme "mitigate[s] firm market power and ensure[s] that consumers receive a reasonable return on life insurance sales . . . . [while also] prevent[ing] companies from taking advantage of seniors and the chronically ill because the secondary life insurance market may be imperfectly competitive."[152] Opponents of the pricing regulations argue "that the minimum payments rule out certain settlements that are otherwise mutually beneficial, thereby distorting the market."[153]

B. *NCOIL Model Act in Comparison to the NAIC Model Act*

The NCOIL has enacted a Model Act similar to the NAIC Model Act, but has not enacted any model regulations similar to the NAIC Model Regulations. Similar to the NAIC Model Act, the NCOIL Model Act has explicit licensing,[154] privacy,[155] and disclosure requirements.[156] In

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149. *Id.*

150. *See* Jay Battacharya et al., *Price Regulation in Secondary Insurance Markets*, 71 J. RISK.& INS. 643, 660 (2004).

151. *See id.*

152. *Id.* at 646.

153. *Id.*

154. LIFE SETTLEMENTS MODEL ACT § 3 (Nat'l Conference of Ins. Legislators 2004).

contrast to the NAIC Model Act, the NCOIL Model Act does not include any minimum pricing regulations and for that it has received praise from industry practitioners that would rather see the market set the price for life settlements.[157] Another critical distinction between the NAIC and NCOIL Model Acts is that the NCOIL Model Act requires that all settlement providers and settlement brokers be licensed by the state in which they are conducting a settlement transaction.[158] As a result, the NCOIL Model Act has received interest from the American Council of Life Insurers, which had previously supported the NAIC Model Act prior to its weakening of licensing requirements.[159]

The disclosure requirements in the NCOIL Model Act are generally similar in nature to the NAIC Model Act with a few subtle, yet important distinctions. First, the NCOIL Model Act requires that "in the case of a life settlement contract in which the insured is terminally or chronically ill[,] the amount and method of calculating the Broker's compensation" shall be disclosed to the policyholder.[160] Furthermore, the NCOIL Model Act requires the Broker to disclose anything of value paid to them relating to the settlement of the life insurance policy *only* if the policyholder of the policy has a terminal or life threatening illness.[161] Conversely, the NAIC Model Act requires disclosure regarding the method and amount of the Broker's compensation for settlements dealing with chronically or terminally-ill individuals *and* any other policyholders that

155. *Id.* § 6.

156. *Id.* §§ 9, 10.

157. *See* Battacharya et al., *supra* note 150, at 646.

158. LIFE SETTLEMENTS MODEL ACT § 3(A) (Nat'l Conference of Ins. Legislators 2004). The NCOIL Model Act does not specifically state whether insurance brokers are required to have extra training to participate in settlement transactions but does require that they be licensed by the state.

159. *See NCOIL Changes Life Settlement Model Law to Strengthen Consumer Protections,*, BESTWIRE, July 22, 2004, *available at* LEXIS, News Library, BestWire.

160. LIFE SETTLEMENTS MODEL ACT § 9(A)(8) (Nat'l Conference of Ins. Legislators 2004).

161. *See id.* at § 11(L).

are selling their life insurance policy.[162] NCOIL's requirement to disclose the commission arrangements for only those settlements dealing with chronically or terminally-ill individuals is limited for no apparent reason. As the NAIC Model Act requires, all life settlement participants should be informed about their broker's compensation, irrespective of their health status.

Another distinguishing point in the NCOIL Model Act is that it requires all fees received for services provided to policyholders for the sale of an insurance policy to be calculated as a percentage of the offer obtained, not as a percentage of the face value of the policy.[163] In many life settlement transactions, commissions can range from two percent to seven percent of the face value of the life insurance policy.[164] While this may seem like a reasonable figure, one must remember that the policyholder does not receive the face value of the insurance policy in a life settlement transaction. Rather, the policyholder receives an amount that is discounted from the face value of the policy. Therefore, the actual commission received can be a much higher percentage of the settlement price because the settlement price is lower than the face value of the policy. For example, a policy owner may hold a life insurance policy with a death benefit of $1 million. A LSP may decide to pay the policy owner $500,000 for that policy. If the life settlement broker's commission is five percent of the face value of the policy, the broker's total commission is $50,000. Alternatively, if the broker's commission is five percent of the life settlement offer, the broker's commission would be $25,000, which is 2.5% of the face value of the policy. In some instances, true commission rates have gone as high as 70.2% because they are expressed as a percentage of the face value of the policy and not as a percentage of the life settlement offer.[165] Astutely, the NCOIL Model Act

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162. *See* VIATICAL SETTLEMENTS MODEL ACT § 8(B)(3) (Nat'l Ass'n of Ins. Comm'rs 2004) (the term viator includes both terminally-ill and non-terminally-ill individuals; therefore, the NAIC Model Act requires brokers to disclose compemsation to all policyholders that sell their policy).

163. *See* LIFE SETTLEMENTS MODEL ACT § 11(K) (Nat'l Conference of Ins. Legislators 2004).

164. *See* GORA, *supra* note 21, at 55 (citing a study completed by Conning & Co.).

165. *See id.* The average un-weighted commission rate is 15.1%.

addresses this by requiring that any fees received be expressed as a percentage of the offer obtained.

As stated earlier, both Model Acts are primarily geared towards protecting the seller versus the purchaser of the life policy; however, both acts do offer protection for the purchaser. For example, the NCOIL Model Act generously allows the purchaser of a life settlement fifteen days to rescind the agreement after the purchase agreement has been executed and the mandatory disclosures have been received.[166] Conversely, the NAIC Model Agreement only allows the purchasers three days to rescind the agreement.[167]

C. *Investor Protection and Securities Regulation*

While the Model Acts and Regulations have primarily focused on the sellers of life insurance policies, state securities regulators and the SEC have focused on protecting investors in back-end transactions. During the 1990s, the victims of the fraud scandals were most often the investors and not the sellers.[168] In 1996, the SEC unsuccessfully attempted to classify the sale of fractional interests of viatical settlements to investors as securities. In *SEC v. Life Partners*,[169] the D.C. Court of Appeals applying the three-part *Howey*[170] test, held that viatical settlement products were not securities because the profits

166. *See* LIFE SETTLEMENTS MODEL ACT § 10(A)(11) (Nat'l Conference of Ins. Legislators 2004).

167. *See* VIATICAL SETTLEMENTS MODEL ACT § 8(F) (Nat'l Ass'n of Ins. Comm'rs 2004).

168. *See* Boris Ziser & Craig Seitel, *Securitization: A Pivotal Phase In The Product's Life Cycle*, NAT'L UNDERWRITER LIFE & HEALTH, Feb. 21, 2005, at 31, 31 (explaining that the viatical settlement market was dominated by individual investors whereas the life settlement market is being dominated by institutional investors). *See supra* text accompanying notes 79-83 (explaining how individual investors were defrauded in the viatical settlement market).

169. 102 F.3d 587 (D.C. Cir. 1996).

170. S.E.C. v. W.J. Howey Co., 328 U.S. 293, 298-99 (1946) (stating that "an investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise.").

were not derived predominately from the efforts of others. While it is not within the scope of this Comment to discuss whether the sale of fractional interests in settlements are securities, it is important to note the result of the court's decision in *Life Partners* and the reaction thereafter by state legislatures.[171] Many state legislators, state courts, and even some federal courts have chosen not to follow *Life Partners* federal precedent. For example, the Southern District Court of Florida, in *SEC vs. Mutual Benefits Corp.*,[172] held that the sale of fractional interests in viatical settlements constituted the sale of securities. In addition to federal district courts, state courts have held that the sale of viatical settlements to investors constituted the sale of securities and therefore fell under the jurisdiction of the states' blue-sky securities regulations.[173]

The State of Ohio, after uncovering a scheme that "defrauded nearly 3,000 investors of more than $100 million[,]"[174] passed legislation based on the NAIC Model Act. Most importantly, the legislation clarified that viatical

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171. The question of whether investments in viatical settlements are securities has been discussed in numerous law review articles. *See* Timothy P. Davis, *Should Viatical Settlements Be Considered "Securities" Under The 1933 Securities Act?*, 6 KAN. J.L. & PUB. POL'Y 75 (1997); Shanah D. Glick, *Are Viatical Settlements Securities Within the Regulatory Control of the Securities Act of 1933?*, 60 U. CHI. L. REV. 957 (1993); Elizabeth L. Deeley, Note, *Viatical Settlements Are Not Securities: Is It Law or Sympathy?*, 66 GEO. WASH. L. REV. 382 (1998); William L. Doerler, Note, SEC v. Life Partners, Inc.*: An Extended Interpretation of the Howey Test that Finds that Viatical Settlements are Investment Contracts*, 22 DEL. J. CORP. L. 253 (1997); Joy D. Kosiewicz, Comment, *Death for Sale: A Call to Regulate the Viatical Settlement Industry*, 48 CASE W. RES. L. REV. 701 (1998); Jennifer A. Lann, Comment, *Viatical Settlements: An Explanation of the Process, An Analysis of State Regulations, and an Examination of Viatical Settlements as Securities*, 46 DRAKE L. REV. 923 (1998).

172. 323 F. Supp. 2d 1337 (S.D. Fla. 2004).

173. *See* Siporin v. Carrington, 23 P.3d 92 (Ariz. Ct. App. 2001); Joseph v. Viatica Mgmt., 55 P.3d 264 (Colo. Ct. App. 2002); Poyser v. Flora, 780 N.E.2d 1191 (Ind. Ct. App. 2003); Michelson v. Voison, 658 N.W.2d 188 (Mich. Ct. App. 2003); Rumbaugh v. Ohio Dep't of Commerce, 800 N.E.2d 780, (Ohio Ct. App. 2003).

174. *Retirement Protection: Fighting Fraud in the Sale of Death: Hearing Before the Subcommittee on Oversight and Investigation of the Committee on Financial Services*, 107th Cong. 47-62, 60 (2002) [hereinafter *Retirement Protection*] (testimony of Lee Covington, Director, Ohio Department of Insurance and Thomas E. Geyer, Assistant Director, Ohio Department of Commerce).

settlements or the sale of fractional interests of viatical settlements to investors are securities under Ohio law and are therefore subject to regulation under Ohio securities regulations.[175] By statutorily classifying settlement investments as securities, the State of Ohio imposed three general requirements on settlement providers. "[F]irst, all persons that sell securities must be licensed or properly excepted from licensure; second, all securities products must be registered or properly exempted from registration; and third, there must be full and fair disclosure of all material terms and conditions of the transaction."[176] In light of the court's decision in *Life Partners*, many states are following Ohio's lead and classifying settlement investments as securities in order to protect investors.[177]

While the classification of life settlement investments as securities by state regulators helps protect investors in the back-end of the transaction, the legal requirements attached to selling securities increases the transaction costs associated with selling life settlement-backed securities. Transaction costs are even further increased because settlement providers will be forced to comply with the blue-sky provisions of each state individually. In order to offset the higher transaction costs, settlement providers may have to decrease the amount paid to policyholders in a life settlement because of the increased back-end costs to maintain a reasonable rate of return on the investment.

LSPs have expressed their opinion through the industry trade association referred to as the Life Settlement Institute (Institute). In a prepared statement, the Institute proposed initiatives to strengthen the regulatory environment surrounding life settlements. [178] The Institute has proposed that the Federal Securities Act of 1933 be amended to explicitly state that the packaging and sale of interests in life insurance policies to private investors be classified as securities under the 1933 Act and therefore fall under the regulation of the SEC.[179] The Institute argues

175. *See id.* at 61.

176. *Id.* at 58.

177. *See id.* at 60.

178. *See id.* at 65-70 (statement of David M. Lewis, President, Life Settlement Institute).

179. *Id.* at 68.

that the "use of institutional funds, with the stringent due diligence requirements that are attendant to its use, is the best way to promote an industry that provides a valuable service to seniors and to protect such potentially vulnerable individuals from fraudulent business practices."[180]

V. CONCERNS GENERATED BY THE NAIC AND NCOIL MODEL ACTS AND SUGGESTIONS TO SHAPE THE LEGISLATIVE FUTURE OF LIFE SETTLEMENTS

A. *Pricing in a New Industry*

The life settlement market includes a handful of recognized, large scale LSPs. With an early developing market, current purchase prices of insurance policies may not represent the true market value of those policies. Furthermore, the minimum pricing requirements[181] set forth in the NAIC Model Regulations run counter to the notion of free market pricing.

Minimum pricing requirements for individuals within certain life expectancy ranges provides an incentive for LSPs to calculate the estimated life expectancy of insured individuals to be outside of the minimum requirements. For example, if an insured's life expectancy is truly twenty-four months, the LSP has an economic incentive to lengthen the life expectancy to twenty-six months. The economic incentive generates from the fact that if the insured's life expectancy is twenty-four months, the LSP has to pay sixty percent of the face value of the policy minus any outstanding loans,[182] whereas if the life expectancy is twenty-six months, the LSP only has to pay an amount above the surrender value. A conflict of interest may arise when one inspects the details of who forecasts the insured's life expectancy. For example, "the doctor who performs medical evaluations for Life Partners, Inc., is himself an owner of 5% of the company."[183] Situations in which the medical professional performing the life expectancy has an economic interest, by way of ownership, can give rise to

180. *Id.* at 68-69.

181. *See supra* text accompanying notes 148-49.

182. *See* VIATICAL SETTLEMENTS MODEL REGULATIONS § 5 (Nat'l Ass'n of Ins. Comm'rs 2004).

183. GORA, *supra* note 21, at 51.

serious conflicts of interest and potential pricing fraud. The problem is further exacerbated by the lack of disclosure in both the NAIC and NCOIL Model Acts to policyholders. The NCOIL Model Act does not require any disclosure regarding the relationship between the person who determines the life expectancy of the insured and the LSP. The NAIC Model Act only requires that a LSP disclose the relationship, if any, to the buyer in the secondary market. Neither Act requires the LSP to disclose to policyholders that their life expectancy, which is one of the main factors in determining the amount that they will be paid for the policy, is being calculated by medical professionals that are being paid by the LSP and in some instances, by medical professionals who have an ownership interest in the LSP.

To rectify the current imbalance, state regulations should include provisions that require disclosure of (1) the nature of any relationship the medical professional has to the LSP, (2) the amount paid by the LSP to the medical professional for services rendered, and (3) a report fully explaining the findings of the medical professional. In addition, policyholders should be allowed to seek their own independent life expectancy projection as a way to verify the accuracy of the LSP's projection.

An alternative to further mandatory disclosure requirements for LSPs is the proposition that regulators should simply do away with the minimum pricing regulations. Pricing floors for certain segments provides an incentive to artificially shift policyholders from a segment that is regulated to one that is not. As it stands, the pricing floors only affect those policies of people who have life expectancies less than twenty-five months.[184] While the argument for pricing floors is that these individuals need the protection of state regulation, the truth is that these individuals have the most sought after policies. In an industry where rate of return is determined by the length of the insured's life, those who are expected to die sooner will receive the most attention when trying to sell their policy. Given the insured's health characteristics, LSPs will naturally be attracted to their policies and will be forced to

184. The pricing regulations only affect those who are terminally-ill because they are designed to protect people who are projected to live twenty-five months or less, thereby classifying them as terminally ill.

actively compete against one another to procure the policy at its true market price. There will be no artificial price floor that will provide an incentive to shift the insured's life expectancy outside of the twenty-five month range. To ensure that policyholders are not being taken advantage of, state legislators should also adopt a mandatory "subject to attorney review" clause in life settlement contracts in addition to the fifteen day rescission period that is currently included.[185]

As the life settlement market begins to evolve, market participants are finding ways to make the market more efficient. For example, an electronic life settlement exchange (e.g., SIMEX)[186] has been established to help facilitate the purchase/sale of life insurance policies in a completely confidential blind auction format. The success of electronic life settlement exchanges is questionable. According to some industry participants, the particular characteristics of each policy make it difficult to standardize a process through a computer system.[187] While the secondary market may not be ready for an electronic exchange such as SIMEX, there is an advantage to having the policy listed on a platform that allows many potential buyers to evaluate the policy.

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185. Perez discusses adding the use of a "legal counsel requirement" provision to the NAIC Model Act. Perez argues that seniors should obtain advice from an attorney or financial planner before entering into a life settlement. Furthermore, Perez argues that the attorney "would be responsible for ensuring that the settlement provider is properly licensed and in good standing within the industry. Additionally, the attorney would make the elder aware of his or her rights as the seller of a life insurance policy to a third party." Perez, *supra* note 119, at 451. Similar to Perez, this Comment supports the belief that a subject to attorney review clause should be added in order to protect the settlement participants; however, this Comment argues that the language should be explicitly added to the actual purchase/sale contract akin to an attorney review clause in a house purchase/sale contract.

186. SIMEX is a life settlement exchange designed to assist life insurance producers and financial professionals in selling their senior clients' life insurance policies to providers (buyers). To generate the highest offers, institutional providers (buyers) login to SIMEX to compete within a blind auction environment for the right to purchase life insurance policies. *See* About SIMEX, http://www.simex.com/advisors_about.html (last visited Feb. 28, 2006).

187. *See* Allison Bell, *Life Settlements Hit The Web*, NAT'L UNDERWRITER LIFE & HEALTH, Sept. 19, 2005, at 12-13.

B. *Conflicts of Interest*

Life settlements present a unique opportunity from a life settlement broker's perspective.[188] Unlike many other financial products, life settlements provide brokers with an opportunity to make above-average commissions.[189] According to the marketing materials distributed to brokers by one LSP, a life settlement transaction can benefit a broker in five different ways: (1) the agent can earn a commission for facilitating the life settlement transaction; (2) the agent, if they are the agent of record on the policy, can keep the renewal commissions that would have been lost if the policy was surrendered or lapsed; (3) many policyholders reinvest the proceeds from a life settlement transaction; therefore, the agent may earn commissions on the reinvestment of the proceeds; (4) the agent may earn a new life insurance commission;[190] and (5) the agent may participate in the conversion commission if the policy being settled is a term policy.[191] With the potential to make money five different ways, the secondary market is tremendously popular amongst the financial planning community. With the monetary incentive to recommend life settlement transactions, regulators need to protect policyholders from ingenious brokers. Regulators should be aware that brokers have such an incentive to complete life settlement transactions and therefore need to address these consumer protection concerns squarely in any regulation passed. The conflict of interest for brokers is apparent because they are receiving money from both sides of the transaction.[192]

The NCOIL Model Act does not do an effective job addressing this issue of broker compensation because it does not require mandatory disclosure to policyholders of

188. The life settlement broker is often the policyholder's life insurance agent or financial planner. *See supra* text accompany note 22.

189. *See* GORA, *supra* note 21, at 55.

190. According to the one practitioner, two out of five life settlements creates a new life insurance sale. *See supra* note 56.

191. *See* Coventry First, How to Turn a Lapse or Surrender into Five Sources of Income, http://www.coventrycenter.org/resource/files/fivesources.pdf (last visited Feb. 28, 2006).

192. In addition to a commission from the policyholder, brokers receive a fee from the life settlement provider for facilitating a life settlement.

compensation paid to brokers in connection with the life settlement.[193] Conversely, the NAIC Model Act requires disclosure to policyholders about compensation paid to brokers in connection with the life settlement transaction. While the current disclosure requirements of the NAIC Model Act are a good starting point, they need to be taken a step further to ensure that policyholders are given fair guidance. When presenting life settlement offers to a policyholder, brokers should be required to disclose the fees they will earn in connection with each particular offer, including any follow-on transactions. Furthermore, any fees should be expressed as a percentage of the life settlement offer and not as a percentage of the face value of the life insurance policy. The rationale behind disclosing the fee arrangements for all life settlement offers is so that policyholders can make an informed decision about which offer to accept. Without knowing the differences in compensation for the broker with each competing offer, it is difficult for the policyholder to accurately judge if the broker's suggestions are genuine or self-motivated.

CONCLUSION

Life insurance and the way we have typically thought about life insurance will continue to change over the coming years. The early development of a secondary market for life insurance policies and the benefit it has brought policyholders and investors illustrates the want and need for this market. Current legislation has provided a good beginning framework for protecting policyholders in a life settlement transaction; however, more is needed in regards to pricing regulations, disclosure requirements, and conflicts of interest. Given the proper legislative attention, the secondary market can become a great source of value to the everyday life insurance consumer even more so than it is today.

193. The NCOIL Model Act only requires disclosure of compensation when the insured is terminally or chronically ill. *See supra* text accompanying note 161.