

# Life Settlements: Investors Beware

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*The authors suggest that investors in life settlements should complete their due diligence before buying.*

The growth of the life settlement industry over the last decade is nothing short of remarkable – a recent study pegged the current market at \$13 billion and projected the industry to grow to over \$160 billion in coming years. The industry involves the purchase of life insurance policies by investors (sometimes called stranger-owned insurance) and in many cases, the subsequent securitization of numerous stranger-owned life insurance policies in large investment pools. *The Wall Street Journal* has publicized this burgeoning market and highlighted the growing concern among regulators regarding life settlements. Lately, life settlements have been the object of increased media attention and industry debate about their legitimacy. With such immense growth potential, institutional investors are entering the market looking to profit from existing practices and attempting to cultivate new ones.

To understand the loud outcry for increased life settlement regulation, investors must be mindful that life settlements represent a battle of titans. In one corner are the insurance companies, seeking to protect the lapse-rate profits they reap whenever a life insurance policy is prematurely canceled. In the other corner are private equity firms and hedge funds, seeking to profit from the guaranteed life insurance policy payouts upon

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the policyholder's death. The insurance companies say life settlements are an improper use of life insurance, while private equity and hedge funds counter that they are simply paying more for an asset than the insurance companies are willing to. These competing interests have already elicited regulatory action and will surely attract more intense efforts in the future.

With this backdrop, any private equity or hedge fund investor seeking to enter the life settlement market should understand that it is wrought with multiple regulatory traps. New York Attorney General Eliot Spitzer, in a case captioned *New York v. Coventry First LLC et al.*,<sup>1</sup> recently sued a leading provider of life settlements, alleging that the provider "orchestrated a broad scheme to defraud owners of life insurance." Mr. Spitzer's primary focus was representations (and omissions) made between the purchaser and the seller of the stranger-owned life insurance. However, in the press release for this suit, Mr. Spitzer, commenting on the life settlement industry, observed that "[t]he situation cries out for both greater regulatory scrutiny and serious soul-searching by the industry and its advocates."

Life settlements have also piqued the attention of the insurance regulators, who, this past May, convened a special meeting that examined the rapid growth of the life settlement industry. Spurred on by so-called "premium financing" transactions, where an investor pre-arranges for an individual to purchase life insurance with a view toward entering into a life settlement, the insurance companies and regulators, in unison, clamored for toughening of existing laws regulating the life settlement industry and implementation of new laws to curb these premium financing transactions. One of the insurance regulators' concerns is whether such "insurance" violates the "insurable interest" requirement (i.e., that the stranger does not have a formidable interest in the life of the individual insured). Another concern is the public policy of preventing the use of insurance policies to gamble on the early demise of another. Various states, the SEC, and NASD have also indicated that life settlements may be subject to securities laws.

## **THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONER'S MODEL ACT**

The National Association of Insurance Commissioners (NAIC) is an organization of insurance regulators, representing all 50 states. The NAIC has drafted a model act, the Viatical Settlements model act to regulate life settlements. To date, different versions of the model act have been adopted by 38 states. For the most part, the model act regulates the dealings between the individual policyholder and the life settlement provider. Among other things, the model act dictates the type of disclosures that must be made to the policyholder and sets forth the manner in which the life settlement provider may complete the purchase of the life insurance policy from the individual policyholder.

## **SIMILAR TRANSACTIONS MAY BE TREATED DISSIMILARLY BY DIFFERENT STATES**

Because different states have enacted different versions of the model act, similar life settlement transactions may be treated differently by different states. For example, this year, New Jersey repealed its old viatical settlement law and replaced it with a more expansive statute that regulates both viatical (viatical settlements involve the purchase of life insurance policies exclusively from terminally ill policyholders) and life settlements. Importantly, New Jersey's statute now requires an individual policyholder to hold the life insurance policy for at least two years before the policyholder can sell it to a life settlement provider. Across the Hudson, in New York, there is no statute that specifically regulates life settlements, and thus no automatic holding period that must be met.

Instead, New York appears to be regulating life settlements by examining particular transactions employed by life settlement providers. At the end of 2005, the New York State Insurance Commissioner issued an advisory opinion that declared certain "premium financing transactions" violative of State Insurance Laws because the policyholder lacked an insurable interest. In making this determination, the Advisory Opinion states that "it is the Department's view that the transaction presented involves the procurement of insurance solely as a speculative investment

for the ultimate benefit of a disinterested third party [...] and is contrary to the long established public policy against “gaming through life insurance purchases.”

Given the fact of dissimilar regulation among the states, life settlement providers, hedge funds and private equity investors cannot easily presume that they are compliant with all pertinent laws affecting life settlements.

## **LIFE SETTLEMENTS MAY BE SECURITIES**

Like many states, in the cases of *SEC v. Mutual Benefits Corp.*<sup>2</sup> and *NASD v. Fergus et al.* (NASD Enforcement Action),<sup>3</sup> the SEC, and NASD have taken the view that life settlements are “securities.” Consequently, offerings and subsequent resales of life settlements, or fractional shares of securitized life settlement portfolios would need to be in compliance with applicable state and federal securities laws.

## **WHY THIS MATTERS TO INSTITUTIONAL INVESTORS AND HEDGE FUNDS**

An obvious prerequisite to any secondary market in life settlements is the assurance that the life insurance policies were procured via an absolute and unrescindable sale. Any cloudiness about ownership would be an untenable risk for any subsequent investor. Not coincidentally, a leading rating agency has announced that necessary preconditions for receiving a rating for a securitized life settlement portfolio are legal opinions. One legal opinion is necessary to verify the legality of the methods and procedures used by life settlement providers to enter into life settlements with individual policyholders. Another legal opinion is required to ensure that the sales of life insurance policies by the life settlement provider to a subsequent investor are absolute unqualified sales, and not a pledge of collateral.

Moreover, a hedge fund or private equity investor must be aware of the securities laws’ issues inherent in any life settlement investment. The unsuspecting investor may be subject to liability for securities laws violations stemming from their involvement in unlawful life settlement transactions.

## CONCLUSION

Given the complexity of the market and the differing practices used by regulators, legal counsel should be retained before any investments in life settlements are made. Are you sure that your life settlement investments are not running afoul of insurance and securities laws? Are you confident that you are taking into account all the insurance and securities regulatory traps that are present in life settlements? As the industry grows, and regulators intensify their efforts, scrutiny will only increase. All this underscores the need for seasoned legal counsel to effectively guide an investor through these challenging but profitable transactions.

## NOTES

- 1 No. 404620-06 (N.Y. Sup. Ct. filed October 26, 2006).
- 2 403 F.3d 737 (11th Cir. 2005).
- 3 Complaint No. C8A990026 (May 17, 2001).