INVESTING IN DEATH:
ARE LIFE SETTLEMENT SECURITIZATIONS THE NEW TREND?

By John P. Cleary, Esq.
Procopio, Cory, Hargreaves & Savitch LLP

JOHN P. CLEARY

Although Wall Street is still littered with the aftermath of the mortgage disaster, investment bankers already anticipate a return to the heady days of hefty fees through securitization and trading of a new asset class – life settlements. To be sure, these investments are a bit macabre because a favorable return on investment is dependent upon the untimely death of another human being. However, they are legal and their popularity is on the rise. Investment advisors and broker-dealers have noticed increased interest in life settlement investments and large investment banks have begun the process of creating life settlement-based derivative securities.

WHAT IS A LIFE SETTLEMENT?

Life settlements grew out of the viatical industry that became popular in the 1980's with many AIDS patients. A life settlement is a secondary market transaction on an insurance policy whereby an insured sells his insurance policy to a third party investor for a lump sum purchase price. The key issues determining market value for a life insurance policy are the amount of the death benefit, the cost of premiums and the life expectancy of the insured.

For the policy owner, a life settlement provides an alternative source of liquidity to simply liquidating the policy for the present cash value. Depending on the age and health of the insured, an investor might pay 20 to 200 percent more than the surrender value an insurer would pay. The investor is obligated to continue paying the premiums on the policy and will receive the death benefit upon the death of the insured. The investor's return depends upon the insured's life expectancy and the actual date of death. If the insured dies before the estimated life expectancy, the investor may receive a higher return. If the insured lives longer than expected, the return will be lower. In sum, the purchaser is hoping and banking on the insured's early demise.

A RETURN TO THE GOOD OLD DAYS

Recently, the New York Times reported there is now a strong demand for life settlement investments. Investment banks are planning to securitize life settlements in the same manner they securitized mortgages before the collapse of the residential mortgage securities market. Securitization is a financing method in which typically illiquid financial assets are pooled together and converted into securities that may be offered and sold in the capital markets. Same as the securitization of mortgages, life settlement securities will have different tranches representing different risk profiles.

Investment banks that sold residential mortgage securities managed their risk by packaging individual mortgages into tranches representing loans from different areas of the country and with different borrower credit risks. The thinking was if the value of homes declined in one area of the country, it would not cause the portfolio to plummet because the risk was diversified. Of course, sponsors of these securities did not account for a nationwide meltdown in housing prices and tightening of credit for even the most qualified borrowers needing to refinance. When that happened, investors lost hundreds of billions of dollars.

Whether securitized life settlement contracts will take off may depend on how credit rating agencies measure the level of risk. As with any securitized bond, a credit agency must rate the bond. The less predictable the outcome of the investment, the tougher it is to rate. Investment banks structuring these pools of risk and credit agencies rating them will need to get a comfort level on issues such as the average human lifespan, factors contributing to remission from disease, treatment methodologies and drugs in the pipeline. To address this, life settlement bonds likely will have policies from a broad range of people with different diseases and varying ages. A life settlement bond with a mix of leukemia sufferers, those with heart disease and individuals over 80 years old will provide a safer risk than, say, a bond with a majority of breast cancer patients. This is because in the event a cure for breast cancer is found, the value of the bond would sink.

In the face of increased interest in pooling life settlements, the insurance industry is calling for tighter controls. Insurers understandably are concerned with a growing market for individuals obtaining life insurance for the sole purpose of reselling it on the secondary market. Historically, a significant percentage of policies have lapsed for nonpayment of premiums, which avoids payment of the death benefit. From the insurers' perspective, a hedge fund sponsoring a pool of life settlements is unlikely to let policies lapse, which will lead to large payouts by insurers that might otherwise have been avoided.

Copyright @2009 Procopio, Cory, Hargreaves & Savitch LLP. All rights reserved.

LEGAL ISSUES WITH LIFE SETTLEMENTS

Last month, the Securities and Exchange Commission (SEC) established a Life Settlements Task Force to examine emerging issues in the life settlements market. The Task Force is considering, among other things, the application of the federal securities laws to life settlements, the issues relating to securitization of life settlements and hedge fund offerings of life settlement-based investments. Also, the Financial Industry Regulatory Authority (FINRA) recently issued a Notice to Members in which it warned brokerage firms and fund managers of the regulatory and compliance issues with life settlement investments.

Are Life Settlements Securities?

The question whether life settlement investments meet the definition of a "security" under federal and state securities laws is crucial. If the investment is a security, the person or entity offering an investment in a life settlement must meet the offering requirements of the Securities Act of 1933, as amended, and is liable for violations of the antifraud provisions of the Securities Exchange Act of 1934, as amended. In addition, those participating in the marketing and selling of life settlement investments would be bound by the broker-dealer registration requirements under state and federal law. Finally, hedge fund operators and investment advisers dealing in life settlements would be bound to comply with the expensive and time consuming requirements of the Investment Advisers Act of 1940 and the Investment Company Act of 1940.

As yet, the courts have not reached a uniform answer to this question. The first case, *SEC v. Life Partners, Inc*[1]., focused on whether participation in a life settlement investment is an investment contract and therefore a "security" subject to the federal securities laws. In that case, the investors were buying a fractionalized interest in a particular life insurance policy. The court held that the offering involved (i) an investment of money (ii) in a common enterprise, which satisfied the first two elements for a security under the standard set by the Supreme Court in *SEC v. W.J. Howey Co.*[2] However, the test failed on the third element from *W.J. Howey*, that the investment be reliant on the "efforts of others." The court found that the investment did not involve a security because the promoters' efforts post-purchase were to simply hold the policy, pay the premiums and wait for the insured to die.

Most courts have not followed the *Life Partners* ruling, either distinguishing the facts or explicitly rejecting the notion that the post-purchase efforts are merely ministerial in nature. Also, in 2004, the D.C. Circuit sided with the SEC in shutting down a $1 billion offering by a viatical settlement company, expressly rejecting the *Life Partners* ruling.

In 2006, FINRA issued Notice to Members 06-38 which stated that, at least for FINRA's purposes, life settlements involving variable insurance policies are securities. In July 2009, FINRA reiterated and expanded on this view in Notice to Members 09-42. FINRA stated that its jurisdiction reaches to "a security that is an interest in a single life policy, or a group or a pool of such policies, whether variable or not."

Accordingly, it will be safer to assume that federal and state securities laws do apply to the purchase and sale of interests in life settlements. Whether the transaction involves an interest in one policy or the sale interests in a pool of life settlements, investment professionals must be aware of and advised on applicable securities laws as they relate to the structuring, marketing, offering and sale of these investments.

Solicitation of Insureds for Life Settlement Transactions

For brokerage firms considering life settlement transactions, FINRA has taken the position this constitutes a material change in a firm's business operations under NASD Rule 1011(k). As a result, prior to engaging in life settlement transactions, a firm must file a Continuing Membership Application and receive approval of the change in business operations under NASD Rule 1017. The SEC Task Force has also warned that it will aggressively investigate whether firms and brokers soliciting policyholders are appropriately licensed to offer and sell securities.

In connection with the solicitation of policyholders to purchase their policies, FINRA has identified certain necessary disclosures such as unexpected tax liabilities, diminished insurable capacity, privacy issues and potentially high commissions.[3] FINRA is particularly concerned with brokers targeting policyholders who are vulnerable to abusive sales practices, including the elderly and seriously ill. It has warned brokers that their duties include discussing alternatives to the sale of their insurance policy if there is a need for cash, including borrowing against the policy or invoking other contract features. Because many life settlements may be securitized, brokers should ensure that a policyholder acknowledges and appreciates that their medical history and private health information may be shared with and monitored by strangers.

Also, the benefits to an insured of selling a life insurance policy must be weighed against the transaction-related costs of a life settlement, which are often substantial. Under NASD Rule 2440 (as adopted by FINRA), a firm is prohibited from charging a customer more than a fair and reasonable commission in any securities transaction. In addition, under FINRA Rule 2010, a firm that charges an unfair commission violates the firm's obligation to observe just and equitable principles of trade in the conduct of the firm's business. Similarly, any fees a firm charges a customer must be reasonable.

As part of a firm's suitability determination under NASD Rule 2310 (as adopted by FINRA), the firm should ensure that policyholders understand the tax treatment of the cash payment when paid in a life settlement as compared to the tax treatment of the death benefit to the beneficiary. The policyholder also should understand that the sale could affect his or her eligibility for certain public assistance programs, such as Medicaid. Also, if a policyholder needs or desires to obtain replacement life insurance, he or she should understand the impact that the life settlement may have on the ability to obtain replacement insurance. Finally, the policyholder should fully

Copyright @2009 Procopio, Cory, Hargreaves & Savitch LLP. All rights reserved.

appreciate and acknowledge that the buyer has a financial interest in his or her death.

Secondary Transactions in Life Settlement Contracts

The second part of the transaction – the purchase of a fractionalized interest in a life insurance policy or a pool of policies – is the focus of the SEC's Life Settlements Task Force. The SEC's concern is that investors in securitized life settlements may not fully understand the complexities of the investment or appreciate the risks involved.

As with any complex financial instrument, fund sponsors should provide full disclosure regardless of the sophistication of the investor or her status as an accredited investor under Regulation D. Key disclosures include, but are not limited to, information relating the structure of the transaction, the mechanics for paying premiums on the underlying policies and the risk of changes in anticipated returns if assumptions and estimates used to value the policies prove to be inaccurate. Because there are multiple parties involved in an investment backed by life settlements (including the insured, the insurance company and the issuer of the securities), each of whom can adversely affect the value of the securities, disclosures must take into consideration each of the principal parties and their related risks.

Of particular importance is to ensure that investors understand and appreciate the risks related to the health and life expectancy of the insureds. Although the SEC is also considering how to balance the need for full disclosure with the privacy rights of the individual insureds, this will require transparency as to the individual lives on which the investment is based, their health conditions, lifestyles and prognoses.

Mr. Cleary is an attorney with Procopio, Cory, Hargreaves & Savitch LLP. Reach him at 619.515.3221 or jpc@procopio.com.

---

[1] *87 F.3d 536 (D.C. Cir. 1996).*
[2] *328 U.S. 293, 298-99 (1946).*
[3] *Notice to Members 09-42.*

Copyright @2009 Procopio, Cory, Hargreaves & Savitch LLP. All rights reserved.