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Miriam R. Albert*

Introduction

Less than two decades ago, AIDS[1] was virtually unknown by most of the world's population. Today, many Americans know of someone who is suffering from or who has succumbed to AIDS. The total number of persons infected with HIV is enormous[2] and growing, albeit at a slower rate than in prior years.[3]

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1. According to the Center for Disease Control and Prevention ("CDC"), acquired immunodeficiency syndrome, or AIDS, is "a specific group of diseases or conditions that are indicative of severe immunosuppression related to infection with the human immunodeficiency virus, [HIV]." CENTERS FOR DISEASE CONTROL AND PREVENTION, HIV/AIDS SURVEILLANCE REPORT, YEAR END 1997 EDITION (1997) [hereinafter CDC REPORT, 1997 EDITION].

2. From the first reported cases of AIDS in 1981 through December 31, 1997, more than 641,000 cases have been reported; the CDC estimates that over 259,000 persons have died of AIDS or related causes between 1991 and 1996. Over 92,000 persons have been reported to the CDC with HIV infection without full-blown AIDS. *See id.*

Through 1997, over 247,000 persons were living with AIDS. *See id.* The CDC believes this figure underrepresents the number of persons with HIV because most HIV-infected persons have not yet progressed to full-blown AIDS, and many persons infected with HIV have never been tested. *See* CENTERS FOR DISEASE CONTROL AND PREVENTION, HIV/AIDS SURVEILLANCE REPORT, YEAR END 1996 EDITION (1996) [hereinafter CDC REPORT, 1996 EDITION].

The expansion of the AIDS crisis affects more than just those afflicted with the disease. Researchers, practitioners, and other healthcare service providers are affected by increases in both the number of AIDS patients and the treatment alternatives available. The sheer number of persons infected, and the dollar amounts involved in treating them,[4] have resulted in the creation of AIDS as a business, encompassing both medical and financial services and innovations.[5]

Despite recent treatment breakthroughs and the continued hope researchers have for finding a way to eradicate this deadly

3. From 1995 to 1996, for the first time in the AIDS pandemic, deaths among persons reported with AIDS decreased by 25%. This decline was in large measure due to the increasing use of combination antiretroviral therapy, including protease inhibitors. *See* CDC REPORT, 1997 EDITION, *supra* note 1, at 5; *see also infra* note 6.

4. AIDS is a financially devastating diagnosis. Typically, with no income from employment, AIDS patients must find money to fund any of the numerous available therapies to treat their illness, ranging from the traditional (in a relative sense, in that AIDS is such a new disease that "traditional" therapies may not even be a few years old) to the experimental. AIDS patients also may need funds to pay for costly home care, in addition to their other bills and living expenses. Insurance coverage, to the extent even available, is by no means comprehensive. *See* Katherine DePeri, *Brokered Viatical Settlement Contracts Are Not Securities - Securities & Exchange Commission v. Life Partners, Inc.*, 70 TEMP. L. REV. 857, 873 (1997).

A 1992 study by the National Association of People With AIDS ("NAPWA") found that over 50% of AIDS patients surveyed lived on less than $12,000 annually. Over half of the survey respondents reported significant difficulties in providing for basic personal needs such as rent, food and medicines. *See* "HIV in America: A Profile of the Challenges Facing Americans Living With HIV," NAPWA, Sept. 1992; *see also* Prepared text of William J. Freeman, Executive Director of the National Association of People With AIDS, Attachment One-C to the Minutes of Insurable Interest Working Group of the Life Insurance (A) Committee of the National Association of Insurance Commissioners, Dec. 8, 1992, 1993-1 NAIC Proc. 779, 786-87.

Predictions of the costs of treating AIDS have grossly underestimated the actual dollar amounts involved. *See* Karen A. Clifford & Russel P. Iuculano, *AIDS and Insurance: The Rationale for AIDS-Related Testing*, 100 HARV. L. REV. 1806, 1807 (1987).

AIDS treatment is very expensive. A 1992 study by the American Medical Association found that HIV patients incur an average of $119,000 in medical expenses from the time of infection with HIV until death from AIDS-related illnesses. *See* Clifford Carlsen, *AIDS Life Policy Purchaser Seeks New Life from IPO*, S.F. BUS. TIMES, Nov. 10, 1995, at 3. This figure pre-dates the costly new protease inhibitors. *See infra* note 42.

5. Because AIDS is so expensive to treat, the huge number of AIDS patients has affected the insurance industry as well. *See* Clifford & Iuculano, *supra* note 4, at 1806.

disease, there is no cure for AIDS.[6] Thus, the AIDS pandemic continues to devastate its victims, both physically and financially. Attempts to alleviate, or at least ameliorate, the physical devastation of AIDS are made by the countless researchers who seek medical advances and by the practitioners who put those advances into effect through new treatment strategies for their patients.

A developing form of asset-backed security,[7] known as a viatical settlement,[8] represents one approach at ameliorating the

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6. In the mid 1990s, researchers announced breakthrough treatments for AIDS involving a combination antiretroviral therapy, including protease inhibitors.

> [The researchers] broke new ground in the theory of how the AIDS virus defeats the immune system in the body. Based on their theory, doctors can now use three different types of drugs at the same time to defeat the AIDS virus. The theory assumes the body is constantly fighting the AIDS virus and over time the virus develops strains that the body cannot defeat. These mutant AIDS strains then multiply and overcome the body's defense system, and a person develops AIDS. By using a combination of new drugs, the body is better able to defeat the AIDS virus. In some small scale experiments it has been demonstrated that the combined use of saquinavir, ritonavir, and indinavir can be effective in containing the AIDS virus. The combination of these drugs with AZT is hundreds of times more effective than just the use of AZT, the most commonly used drug.

David W. Sommer et al., *Viatical Settlements: Perspectives of Investors, Regulators and Insureds*, J. SOC'Y C.L.U. & CHFC 54, 56-57 (Mar. 1997). These new treatments have "altered the natural history of HIV infection, contributed to an increase in the number of persons living with AIDS, and changed the shape of the epidemic curves." CDC REPORT, 1997 EDITION, *supra* note 1, at 5.

7. Asset-backed securities are claims on cash flows from pools of similar assets. The assets are packaged and sold to investors who receive the interest and principal payments from these cash flows. *See Asset-Backed Securities Is Booming Field for Issuers*, CARD NEWS, Apr. 1, 1996.

Asset-backed securities are increasingly popular today, with investors purchasing the right to receive income streams from any number of different kinds of income-producing assets, ranging from lottery winnings, legal settlements, electric bills, and future royalties on rock and roll songs to death benefits payable under life insurance policies held by the terminally ill. *See* Douglas Brown, *Jackpot! Legal Settlements, Lottery Winnings May Be Next in Line for Securitization*, BOND WEEK, May 20, 1996, at 1; *see also* Leslie Eaton, *You Too Can Become a Tradeable Security, Rated AAA* (last modified June 7, 1998) <http://www.nytimes.com>. David Bowie raised $55 million by selling bonds collateralized by the right to receive future royalties on his songs. *See id.*

8. The term "viatical" comes from the Latin word "viaticum" which is the Eucharist or communion given to Christians who are dying or are in danger of death; to the Romans, it meant money or provisions for a journey, but the term came to refer to the last rites—something to sustain the deceased person on his or her "last journey." *See* THE AMERICAN HERITAGE DICTIONARY OF THE AMERICAN LANGUAGE

financially devastating aspects of AIDS.[9] This specialized form of receivable financing gives life insurance policyholders access to death benefits under their policies that would be otherwise unavailable to them during their lives.

In the typical viatical settlement, a terminally-ill policyholder, known as a viator, sells the right to receive the proceeds of his or her life insurance policy to an investor. During his or her lifetime, the policyholder is paid an estimation of the present value of the death benefits under the policy, calculated based on such factors as projected life expectancy, the face value of the policy, and the cost of at least two years of future premi-

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1988 (3d ed. 1996); *see also* David Jay Korn, *Viaticals: When Sooner Is Better Than Later*, ACCT. TODAY, Jan. 19, 1998 (for a description of the viatication process).

9. Another vehicle to provide terminally-ill policyholders with access to life insurance benefits while they are alive are "accelerated death benefit" ("ADB") provisions in traditional insurance policies. The insurer guarantees the payment of the policy face value upon the death of the insured, as long as the policy is then in effect. The insurer is under no obligation to advance any portion of the death benefit to the insured in the absence of an ADB provision.

ADB provisions can be included in the initial policy, or can be added as riders or attachments to new or existing policies. Unlike viatical settlements, ADB provisions typically provide that a portion of the face value benefit be retained as a death benefit for the traditional beneficiary. An ADB provision typically pays a smaller percentage of the face value of the policy than a viatical settlement and is subject to more stringent requirements on availability, in terms of triggering conditions. ADBs are typically only available to insured persons with life expectancies of less than one year, whereas viatical settlements can be made with viators with much longer life expectancies.

In an ADB provision, the issuing insurance company pays benefits directly to the insured, unlike a viatical settlement where some third party advances funds to the insured. Other differences between ADB provisions and viatical settlements include: ADB payouts can be slow, while viatical settlements are typically paid within a few weeks; ADB provisions are typically limited to universal and whole life policies, while viatical settlements can be made on a much wider range of policy types; and insureds must deal exclusively with the issuing insurance company with ADBs, while insureds can shop their policies to various viatical settlement firms. *See* Sharon Crockett & Lynn Homa, *Viatical Settlement Firms Look to Securitize*, STANDARD AND POOR'S CREDITWEEK, Apr. 3, 1995, at 1; *see also* Abbie Crites-Leoni & Angellee S. Chen, *Money for Life— Regulating the Viatical Settlement Industry*, 18 J. LEG. MED. 63, 80-81 (1997); *see also* Sheila D. Foster, *Viatical Settlement: A New Employee Benefit*, MANAGEMENT ACCT., May 1998, at 55. *See, e.g.*, Alexander D. Eremia, *Viatical Settlement and Accelerated Death Benefit Law: Helping Terminal, but Not Chronically Ill Patients*, 1 DEPAUL J. HEALTH CARE L. 773, 784 (1997), for a comparison of ABD provisions and viatical settlements.

Additional vehicles that provide access to otherwise unavailable assets include reverse mortgages and sale-leaseback arrangements coupled with a life estate on residential properties. *See id.* at 774.

ums, which, under most viatical settlement agreements, becomes the responsibility of the investor, absent a disability waiver of premiums.[10]

The investor's return is the difference between the death benefits ultimately paid, presumably the policy's face value, and the discounted amount paid to the policyholder. Thus, the return depends primarily on the date of the viator's death, and, to a lesser extent, on the speed with which the insurance company is notified and ultimately pays out on the policy.

Viatical settlements are legal and serve a benevolent purpose. However, beyond the altruism of providing funds to the terminally ill, and the legalities of simply selling the right to receive life insurance proceeds to someone other than the insured, viatical settlements pose other legal and ethical issues.[11] Because viatical settlements have not yet been classified as investment contracts, and thus securities for purposes of the federal securities laws, investors in viatical settlements must gather information themselves on which to base their investment decisions. Furthermore, investors are denied the protections and remedies provided by the federal securities laws, and have only a common law fraud remedy to redress misleading statements or omissions by viatical settlement firms. The specter of conflicts of interest, confidentiality problems, and the serious threat of fraud looms over the viatical settlement industry, and in the absence of appropriate regulation, threatens the very stability of this compassionate and increasingly popular financial innovation.

The typical viatical settlement has a purchase side, wherein some person or entity purchases the life insurance policy from the terminally-ill policyholder, and a sale side, wherein the new owner sells either an entire policy, or fractional inter-

10. A disability waiver eliminates the need to pay premiums on the insurance policy and is typically renewable as long as the disability exists. *See* Malcolm E. Osborne, *Rapidly Developing Law on Viatical Settlements*, 31 WAKE FOREST L. REV. 471, 489-90 (1996).

11. Commentators have raised concerns about insurable interests and complications in the assignment of policies, and about the effect of an absolute assignment of a policy on a waiver of premium clause in connection with a viatical settlement. *See id.* at 485-90.

ests in a policy or a pool of policies, to investors.[12] The initial purchase of life insurance policies by viatical settlement firms from terminally-ill viators is subject to some regulation at the state level, typically by a state's insurance department. Twenty-four states regulate the purchase side of viatical settlements; another eight states are considering such legislation.[13]

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12. There are three basic scenarios for viatical settlement transactions. First, the viator may sell his or her policy directly to an investor who holds the policy until the viator dies and then collects the death benefits. Second, a viator may use a broker who matches up viators and investors for a fee, and never assumes an ownership interest in the policy. Third, the viator may sell his policy to a firm who then sells fractional interests in such policy, or pools the policy with other policies and sells fractional interests in the pool. *See* Elizabeth L. Deeley, *Viatical Settlements Are Not Securities: Is It Law or Sympathy?*, 66 GEO. WASH. L. REV. 382, 386 (1998).

This Article focuses on the third scenario, as that is the only scenario that arguably results in the sale of a security for purposes of the federal securities laws, triggering the need for the protections thereunder. In *SEC v. Life Partners, Inc.*, 87 F.3d 536 (D.C. Cir. 1996), the D.C. Circuit Court of Appeals considered the status of fractional interests in viatical settlements as securities. The court obliquely eliminated the first two scenarios as constituting securities:

> [P]resumably a firm might also buy insurance policies for its own account or act as an agent, matching a single investor with a terminally ill insured, without running afoul of the securities laws.

SEC v. Life Partners, Inc., 87 F.3d 536, 539 (D.C. Cir. 1996).

13. Arkansas, 1997 Ark. Acts 490, approved by the Governor Mar. 13, 1997; California, CAL. INS. CODE §§ 10113.1 to .2 (Deering 1996); Connecticut, 1997 CONN. ACTS 202 (Reg. Sess.), approved June 24, 1997; Florida, FLA. STAT. 626.991 to .993 (1996); Illinois, 215 ILL. COMP. STAT. 158/1-95 (West 1996), approved June 21, 1996); Indiana, IND. CODE §§ 27-8-19.8-27-8-19.8-26 (1994); Kansas, KAN. STAT. ANN. §§ 40-2,140 - 152 (1992); Kentucky, 1998 Regular Session, H.B. 414, approved Apr. 7, 1998; Maine, ME. REV. STAT. ANN. tit. 24-A, §§ 6801 to 16, (West 1997) enacted June 10, 1997; Michigan, MICH. STAT. ANN. §§ 24.569(1)-(8) (Law. Co-op. 1996); Minnesota, MINN. STAT. §§ 60A.961 to .974 (1996); Montana, 1997 Mont. Laws 298, approved Apr. 18, 1997; New Mexico, N.M. STAT. ANN §§ 59A-20-34-36 (Michie 1989); New York, N.Y. INS. LAW §§ 7801 - 10 (Consol. 1993); North Carolina, N.C. GEN. STAT. § 58-58-42 (1995); North Dakota, N.D. CENT. CODE §§ 26.1-33.1-01-26.1-33.1-10 (1995); Oklahoma, S. 791, 46th Leg., 2d Sess. (Okla. 1997); Oregon, 1995 Or. Laws 342; Texas, TEX. INS. CODE ANN. § 3.50-6A (West 1993); Utah, UTAH CODE ANN. § 31A-21-104 (1994); Vermont, VT. STAT. ANN. tit. 8, §§ 3826-3832 (1994); Virginia, 1997 Va. Acts ch. 814, approved Apr. 2, 1997; Washington, WASH. REV. CODE §§ 48.102.005 to .901 (1995); Wisconsin, WIS. STAT. § 632.68 (1996).

In addition, as of October 1, 1998, eight states were considering some form of regulation for the viatical settlement industry: Delaware, S.B. 39, 139th Gen. A. (Del. 1997); Hawaii, H.B. 580, 20th State Leg. (Haw. 1991); Iowa, S.B. 354, 78th Gen. A. 1st Sess. (Iowa 1997); Massachusetts, H.B. 27, 181st Gen. Ct. (Mass. 1997); Missouri, H.B. 1019, 90th Gen. A. (Mo. 1998); New Hampshire, H.B. 263, 1997 Reg. Sess. (N.H. 1997); New Jersey, A.B. 2712, 208th Leg. (N.J. 1997); Ohio, These regulations cover, among other topics, minimum payments for policies, pre-signing disclosures to viators, and licensing of viatical settlement firms.[14] These regulations focus on the purchase of the policy from the viator, and not on subsequent sales to investors, which this Article argues should be subject to additional regulation through state and federal securities laws.[15]

The sale of fractional interests in viatical settlements is currently not subject to meaningful regulation at either the state or federal level.[16] The legislative intent of the federal securities laws was to prevent fraud through the disclosure of information necessary to make meaningful investment decisions.[17] The potential for fraud in this developing industry is high, and there is no mandatory disclosure to investors. Because fractional interests in life insurance policies constitute investment contracts, investors therein should be granted the protection of the Securities Act of 1933, as amended ("Securities Act")[18] and the Securities Exchange Act of 1934, as amended ("Exchange Act").[19] The viators themselves would be indirect beneficiaries of this change. In the absence of the necessary protections provided by the Securities Laws, investors may ulti-

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H.B. 12, 122nd Gen. A. (Ohio 1997); Pennsylvania, H.B. 1127, 183rd Gen. A. (Pa. 1997); and South Carolina, H.B. 3542, 112th Sess. of the Gen. A. (S.C. 1997).

14. The coverage of the existing and proposed viatical legislation protects viators and is beyond the scope of this Article. For a full discussion of the appropriateness of these legislative initiatives, *see* Osborn, *supra* note 10.

15. *See* Deeley, *supra* note 12, at 382.

16. Certain states are starting to consider legislation to regulate fractional interests in viatical settlements as securities. Arizona recently enacted a statute, which specifically includes viatical settlements in the definition of security. *See* ARIZ. REV. STAT. § 44-1801(23) (1998). South Dakota recently enacted a statute which specifically includes viatical settlements in the definition of security. *See* 1999 S.D. SB 48 (1999). However, the statute provides an exemption from registration for viatical settlements offered by companies in compliance with Title 58, regulating insurance in South Dakota. *See id.* Further, the Securities and Exchange Commission is actively involved in the effort to regulate fractional interests in viatical settlements as securities. *See infra* Part IV for a discussion of the Mutual Benefits case and states' efforts to regulate fractional interests in viatical settlements.

17. *See infra* notes 136-60 and accompanying text for a discussion of background and goals of the federal securities laws.

18. 15 U.S.C. §§ 77a-h (1994).

19. 15 U.S.C. §§ 78a-h (1994). For purposes of this Article, the nomenclature "Securities Laws" means both the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended.

mately decide not to invest in viatical settlements, taking with them the life blood of this industry.[20] The Securities and Exchange Commission ("SEC") was unsuccessful in its first bid to classify fractional interests in viatical settlements as investment contracts under the Securities Act, in the recent case of *SEC v. Life Partners, Inc.*[21] Despite its setback in *Life Partners*, the SEC has not given up its efforts to regulate fractional interests in viatical settlements.[22] Some states are also considering the classification of certain forms of viatical settlements as securities.[23]

Part I of this Article presents an overview of the evolution of the viatical settlement industry, as it responds to changing life expectancies of AIDS patients resulting from new drug treatments and to viatical settlement firms' attempts to diversify by viaticating policies of patients suffering from illnesses other than AIDS.

Part II of this Article raises the ethical issues imbedded in viatical settlement transactions, including conflicts of interest, confidentiality concerns, and fraud, all of which should be disclosed as risk factors to investors in viatical settlements.

Part III of this Article considers the classification of viatical settlements as securities for purposes of the Securities Laws. Part III examines the legislative history and case law interpreting the Securities Laws, critiquing the holding in *Life Partners* that fractional interests in pools of viatical settlements do not constitute securities as defined in the Securities Act and its interpretive case law. Part III concludes that fractional interests

20. The dollar amount of policies viaticated has increased continually since the first viatical settlements in the late 1980s. *See infra* Part I for a discussion of the viatical settlement industry. Although there are investors who are presently willing to do without the protections of the Securities Laws, if the fraud in this industry worsens, such investors may elect to put their investment funds elsewhere. Offering investors the protection of the Securities Laws may serve to keep such investors in the viatical settlement market, and may attract new investors, making the viatical settlement market broader and more liquid.

21. SEC v. Life Partners, Inc., 87 F.3d 536 (D.C. Cir. 1996), *reh'g denied*, 102 F.3d 587 (D.C. Cir. 1996); *see infra* Part III for a discussion of this litigation.

22. The SEC does not take the position that all viatical settlements are securities; it focuses on the sale of fractional interests in policies to multiple investors. *See supra* note 12 for a description of the three scenarios for viatical settlements; *see also infra* note 130; *infra* Part IV for a discussion of the *Mutual Benefits* case.

23. *See infra* Part IV for a discussion of states' efforts to regulate fractional interests in viatical settlements.

in viatical settlements fall within both the spirit and the letter of the Securities Laws, and thus should be considered securities in order to further the legislative goals of the Securities Laws.

Part IV of this Article explores the viatical settlement industry after *Life Partners*, focusing on the efforts of some states to classify certain forms of viatical settlements as securities, and the SEC's continued efforts to achieve the investor protection denied by the court in *Life Partners*.

I: The Changing Face of the Viatical Market

Viatical settlements have become increasingly popular since their inception in the late 1980s,[24] developing primarily as a response to the AIDS crisis. The annual volume of the industry is estimated at over $500 million, with estimates of up to $1 billion by the year 2000.[25]

The viatical settlement industry has continued to grow and change dramatically over the first decade of its existence.[26] To a large extent, the viatical market was, and continues to be, de-

24. There are two competing theories concerning who actually completed the first viatical settlement in the late 1980s. Rob Worley, of Living Benefits Inc., an Albuquerque, New Mexico viatical settlement firm, has been credited as the first person to explore viatical settlements. Worley was listening to a radio call-in talk show featuring a 36-year-old caller with no family who had learned that he had only months to live. The caller's only asset was a large life insurance policy, which he tried unsuccessfully to sell to insurance companies and banks.

Mr. Worley researched the relevant laws and surveyed insurance industry participants about available alternatives for the terminally-ill policyholders, and then bought his first policy, through Living Benefits, in April 1989. *See* Nancy L. Bruer, *Financial Help for the Terminally Ill*, PERSONNEL J., Jan. 1993, at 78.

Others claim that viatical settlements were developed by an HIV-positive financial planner, David Petersen, who started the first viatical settlement company to help some of his dying friends. *See* Arthur Allen, *As They Lay Dying*, WASH. POST, Nov. 17, 1996, at W13.

25. Because annual reporting requirements by viatical settlement firms are neither mandatory nor uniform, a verifiable estimate of the dollar volume or number of policies viaticated is not yet possible. There is a wide disparity in the available estimates. *See* Albert B. Crenshaw, *Tackling an Issue of Agony; Ruling May Ultimately Aid the Business of Buying Death Benefits*, WASH. POST, Sept. 1, 1995, at C1; *see also Viatical Association Drafts Its Own Model Laws*, BESTWIRE, Nov. 5, 1996.

26. One catalyst for growth was the enactment of the Health Insurance Portability and Accountability Act of 1996. Pub. L. No. 104-191, 110 Stat. 1936 (codified as amended in scattered sections of 42 U.S.C). The statute makes proceeds from viatical settlements exempt from federal income taxes in most cases. The statute conferred tax-free status on viatical settlements paid after December 31, 1996 to

pendent on AIDS and HIV-infected policyholders to supply the raw materials for viatication — life insurance policies, in good standing, held for more than two years (so any applicable contestibility period has expired).[27] Thus, the viatical industry is very sensitive to factors affecting life expectancies of viators, such as new treatments for various illnesses, primarily those associated with HIV and AIDS, that may affect the purchase price paid for policies and the ultimate return to investors.[28]

When researchers at the August 1996 World AIDS Conference in Vancouver announced that protease inhibitors could prolong the lives of some AIDS patients,[29] the viatical settle-

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viators with a life expectancy of less than two years by a viatical settlement firm licensed in the state where the viator lives.

There may be additional taxes on viatical settlement proceeds at the state and local levels. To achieve consistency with this new federal legislation, other states are expected to adopt legislation making viatical settlements tax free. New York and California confer tax-free treatment on the proceeds of viatical settlements. However, most states still follow the old federal rule, holding proceeds of viatical settlements as taxable to the extent the proceeds exceed the viator's tax basis in the policy. *See* Sommer et al., *supra* note 6, at 59.

For a discussion of the general tax issues arising in connection with viatical settlements, *see* Osborn, *supra* note 10; *see also* Denise M. Schultz, Comment, *Angels of Mercy or Greedy Capitalists? Buying Life Insurance Policies from the Terminally Ill*, 24 PEPP. L. REV. 99, 103-106 (1996). For a discussion of the tax treatments of viatical settlements as compared to ABDs, *see* Eremia, *supra* note 9, at 787-91.

27. *See infra* Part II for a discussion of incontestability clauses.

28. *See supra* note 6.

29. Protease inhibitors have affected more than just the viatical settlement market. Because AIDS is no longer considered a death sentence, some insurance companies are now experimenting with selling life insurance policies to HIV-infected applicants.

In April, 1997, Guarantee Trust Life Insurance Co., of Glenville, IL, a firm specializing in insuring impaired individuals, began offering whole life coverage to some HIV-positive applicants. The president of Guarantee Trust said the company undertook this change because "we believe many otherwise healthy HIV-positive individuals are more appropriately viewed as having a treatable chronic illness rather than a terminal disease." *See* Greg Lugliani, *Body Positive - July 1997* (visited Mar. 22, 1999) <http://www.thebody.com/bp/july97/news.html#life>. These policies are much more expensive than typical life insurance, to compensate the insurer for the additional risk of the insured's HIV-positive status. *See id.*; *see also* Sommer et al, *supra* note 6, at 55.

The coverage was made available to certain people age 20 to 49 with HIV, but not full-blown AIDS. *See Insurer Flooded With Queries About HIV Life Policy*, BESTWIRE, Apr. 23, 1997. The insurance is not available to patients who contracted HIV through the injection of drugs. The company fears that drug use "creates incalculable risks for the company, including the chance that drug users won't take their health-sustaining medications." Lugliani, *supra.*

ment industry was thrown into a state of flux.[30] This news was eagerly anticipated by AIDS and HIV patients and advocates,[31] but had other implications for some viatical settlement firms.[32]

Guarantee Trust decided to insure the lives of certain HIV-positive applicants after months of research and developmental work, including studying data from CDC, insurance industry mortality tables, information from its reinsurer, interviews with local doctors treating HIV-infected patients and with national HIV experts, and consultations with people in the HIV community and consultants who work with them. *See* Linda Koco, *Guarantee Trust Looks at Applicants with HIV*, NAT'L UNDERWRITER, Apr. 21, 1997, at 13.

This program has significance for the insurance industry, and, depending on the number of policies issues to HIV-positive applicants, may also affect the viatical settlement industry; after the incontestability period expires, these Guarantee Trust policyholders may seek to viaticate their policies. *See infra* Part II for a discussion of incontestability clauses.

30. *See* Beth Ashley, *Changes Prove Fatal for Some Viatical Companies; Survivors Alive, Well*, GANNET NEWS SERVICE, Feb. 18, 1998, at ARC. The news was not all necessarily bad for the viatical settlement industry. The new treatments are expensive, and thus would fuel demand for viatical settlements from viators. The irony is that these costly medical advances arguably make viatical settlements a less attractive investment, or at least subject to a deeper discount, based on the increased life expectancies of viators availing themselves of the treatments. *See* Sommer et al, *supra* note 6.

31. While no one was claiming a cure for AIDS, the idea of a cure seemed less unthinkable than ever before. *See* Lawrence K. Altman, *With AIDS Advances, More Disappointment*, N.Y. TIMES, Jan. 19, 1997, at 14; *see also* Joel Lang, *Redesigning Destiny: New Drugs Have Added Ups and Downs to the AIDS Roller Coaster*, HARTFORD COURANT, Mar. 30, 1997, at 10. AIDS activists worried that a public perception that AIDS was almost curable would dry up funding and public interest in actually achieving a cure. *See* Bob Condor, *New Drugs Kindle Hope Among HIV Patients*, CHI. TRIB., Apr. 13, 1997, at 1.

32. One casualty of the new protease inhibitors was San Francisco-based Dignity Partners, a viatical settlement company that was once a media darling. *See Dignity Partners Announces Second Quarter Earnings*, BUS. WIRE, Aug. 14, 1996. Dignity Partners was the first firm to sell notes securitizing the proceeds of viaticated policies, and the first viatical settlement firm to sell shares in a registered offering. *See Ironwood Capital and Dignity Partners Completes the First Ever Asset Securitization of Viatical Settlements in the Amount of $35 Million*, BUS. WIRE, Mar. 2, 1995. Standard & Poor's gave the 1995 public offering of $35 million of notes an "A" rating, and as a reflection of the market's optimism about the future of the viatical settlement industry, published new rating criteria for viatical settlement deals in November, 1995. *See id.*

In complying with its disclosure obligations under the Securities Laws, Dignity listed as a risk factor in its prospectus for the initial public offering that:

> the development of a cure or vaccine against diseases and other terminal illnesses (including AIDS) or the development of a treatment which extends the life expectancy of individuals with such illnesses could delay substantially the collection of the face value of policies purchased by the company. . . Any such delay could materially reduce the company's actual yield on its portfolio.

Carlsen, *supra* note 4, at 3.

Dignity had been attempting to diversify its portfolio, hoping to viaticate policies from AIDS patients with life expectancies in excess of 24 months, and policies from patients with other terminal illnesses. *See* Anne Colden, *Dignity Partners' Future May Be Murky as AIDS Mkt. Shifts*, Dow Jones News Service, July 29, 1996. However, in light of the reports from the Vancouver World AIDS Conference in 1996, Dignity instead announced that because over 95% of its viatication business had been with AIDS- and HIV-infected viators, it would temporarily cease processing any new applications from that population. *See Despite Win Over SEC, Viaticals' Profits Face Threat*, BestWire, July 19, 1996 [hereinafter *Profits Face Threat*].

According to Dignity, the medical developments announced at the conference were welcome news for many, but, if the treatments prove to be effective in the long term, Dignity's results would be adversely affected. Following this announcement, Dignity's stock dropped by 77% in one day. *See* Colden, *supra*. Dignity began selling off its policies and repurchasing its shares to correct what it perceived as an overreaction by the market to its announcement. *See Dignity Partners Announces Share Repurchase Program*, Bus. Wire, Oct. 18, 1996.

Life Partners called Dignity Partners "an insignificant player in the viatical market" and said that Dignity was using the new treatments for AIDS as a "poor excuse to get out of the market." *Profits Face Threat, supra.*

Dignity later decided to cease its viatical settlement business and to sell off its non-AIDS policies.

> During the third quarter of 1996, the company concluded that the efficacy of the treatments reported at the AIDS Conference and substantially reported treatments increased the risks of purchasing and holding policies insuring the lives of individuals diagnosed with HIV or AIDS, especially those with longer life expectancies. The company also reported that it does not believe it is viable to continue to operate a viatical settlement business solely for non-AIDS policies while a market for non-AIDS policies develops, if it develops at all. As a result, the company reported that the board of directors had recently decided to cease the company's viatical settlement business and approved the sale of the company's non-AIDS policies.

Dignity Partners Announces Earnings, Sale of Policies, Sale of Equity Investment and Cessation of Viatical Settlement Business, Bus. Wire, Mar. 31, 1997, at 1.

Other firms were slowly and less publicly undertaking the same course of action as Dignity — weaning their portfolios from an almost exclusive reliance on AIDS- and HIV-infected policyholders, and seeking out policyholders suffering from other terminal illnesses. *See* David W. Dunlap, *AIDS Drugs Alter an Industry's Math: Recalculating Death-Benefit Deals*, N.Y. Times, July 30, 1996, at D1.

Fearful of a mass exodus from this blossoming industry, the National Viatical Association ("NVA"), an industry trade group, issued its own press release entitled "Protease Inhibitors Are Not Inhibiting All Viatical Settlement Firms." The release reiterated remarks of some speakers at the World AIDS Conference that the new treatments were not a cure, finishing up with a pledge to continue to provide AIDS patients with viatication opportunities "as part of a series of viable financial options, which can offer fiscal dignity during the most trying times." *See* Press Release of National Viatical Association, July 25, 1996.

As the perception of AIDS began to shift from a disease from which one dies to a disease with which one lives,[33] the viatical market responded.[34] The pool of selling policyholders has shifted from solely AIDS and HIV-infected persons, and now includes policyholders suffering from a wide range of illnesses, such as Alzheimer's disease, heart disease, stroke, cancer, and, in some cases, just old age.[35] This shift is, at least in part, a result of the changes in the treatments for AIDS that may alter the life expectancy of some AIDS and HIV-infected persons, and the corresponding recognition of the need to diversify by viaticating policies of patients with other terminal illnesses.[36] Industry participants also credit the changing composition of the

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33. *See* Altman, *supra* note 31, at 14.

34. The infectious optimism of the 1996 World AIDS Conference was muted by the sobering and tempered reports from the 1998 World AIDS Conference in Geneva. The participants cautioned that simply lowering a patient's viral load to an undetectable level did not mean that the disease was gone. Instead, it was simply hiding, with the potential to come back at some future point in time. *See* Kim Roller, *Twelfth World AIDS Conference; Experts Examine Latest HIV Options*, DRUG STORE NEWS, Aug. 24, 1998, at CP54.

Thus, while protease inhibitors and their encouraging results for AIDS patients had a chilling effect on at least part of the burgeoning viatical settlement market, the new therapies are not universally effective, and no one has been cured yet. The virus remains dormant in cells, with the ever present potential to come back. One clinical study found that 86% of patients had no detectable trace of the virus after 48 weeks on protease inhibitors, while the remaining 14% saw the virus return. *See New AIDS Drugs Restoring Vitality*, SAN ANTONIO EXPRESS-NEWS, Sept. 3, 1996, at 10.

35. *See* Eremia, *supra* note 9, at 785-87; *see also* Charles E. Schmidt, Jr., *Viatical Firms Fighting Outlaw Image*, BEST'S REV. - LIFE-HEALTH INS. ED., Mar. 1996, at 69.

A program called "Senior Settlements" permits healthy seniors, typically over 70, to viaticate their life insurance policies. One viatical settlement firm, Viaticus, Inc., expects to purchase up to $300 million in policies in 1998, 80% of these from relatively healthy people. *See* Joseph B. Treaster, *Death Benefits, Now for the Living*, N.Y. TIMES, Sept. 27, 1998, § 3, at 1; *see also Viatical Industry Expands to Include New Financial Opportunities For Seniors — Senior Settlements Help The Elderly Market Cash in on Their Life Insurance*, BUS. WIRE, Apr. 14, 1998; *Viaticus Adds Seniors*, BEST'S REV. - LIFE-HEALTH INS. ED., Dec. 1997, at 89; Korn, *supra* note 8.

According to one viatical settlement firm, senior citizens are considered to be a big market for viatical settlements because seniors often are the demographic with chronic illnesses. However, some viatical settlement firms are offering viatication to seniors age 75 and over, even without a life-threatening or chronic condition. *See Viatical Settlements: Big New Senior Product in Financial Planning Business*, MATURING MARKETPLACE, Mar. 11, 1997, at 1.

36. *See* Eremia, *supra* note 9, at 786.

pool of viators to the increasing acceptance of viatication as a legitimate financial vehicle.[37]

The growing pains evident in the viatical settlement industry highlight certain risks inherent in these transactions, to both viators[38] and to investors.[39] Merely identifying these risks

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37. Viaticus, Inc. began a two-pronged campaign to legitimize viatical settlements. The company engaged first in federal and state lobbying campaigns, pressing for the regulation of the viatical settlement industry in an effort to prevent fraud and to standardize viatical payouts. The second prong of the attack was a campaign to achieve tax-free treatment for the proceeds of viatical settlements. *See Marketing a New, Complex Financial Option For Terminally Ill*, HEALTHCARE PR AND MARKETING NEWS, Oct. 16, 1997.

Both prongs of Viaticus' efforts were realized; 25 states now regulate viatical settlements, and Congress passed HIPPA, making viatical settlements tax free for viators with life expectancies of less than two years. *See supra* note 13 for a list of state regulations on viatical settlements; *see also supra* note 26 for a discussion of the tax legislation.

The increasing respectability and popularity of viatical settlements may prove troublesome to the insurance industry. Insurers set premiums on policies based on a statistical expectation that some percentage of the polices will be abandoned, and thus no death benefits will be due thereon. If viatical settlement firms continue to intervene, and purchase some or all of the policies that would otherwise be abandoned, insurance companies will end up paying out more than planned. This could lead to increases in premiums on policies, and even a corresponding decrease in sales. *See* Korn, *supra* note 8.

38. Viators are exposed to three primary risks in the viatication process. First, viators run the risk of losing income-derived benefits, such as welfare or Medicare, as a result of the sale of their policy. Second, viators run the risk that their private medical history furnished to the viatical settlement firm will somehow become more publicly disseminated. Third, viators run the risk that the advent of new drug therapies will make their life expectancies so uncertain as to drive investors from the viatical settlement market, or valued so low as to make such investments not financially worthwhile, in either case eliminating viators' access to death benefits during their lives. For a full discussion of the risks to viators, *see generally* Miriam R. Albert, *Selling Death Short: The Regulatory and Policy Implications of Viatical Settlements*, 61 ALB. L. REV. 1013 (1998).

39. Investors in viatical settlements are also exposed to certain risks. There is a substantial financial risk, where the ultimate return on this investment is tied to the actual lifetime of the viator. Investors know how much they will get, but the date of the payment is uncertain. Thus, the risk is that the effective return declines as the payment dates gets further away from the estimated date of death. *See* Amy S. Friedman, *Banks Now Selling Viatical Settlements*, NAT'L UNDERWRITER, Nov. 3, 1997, at 41. The viator may outlive his or her projected life expectancy, diminishing the return to the investor. Because AIDS is such a new disease, no reliable mortality tables have been established yet. There are no long-term studies on the effectiveness of the new drug treatments, and, although the new treatments do not cure AIDS, they seem to extend the lives of certain AIDS patients. For investors in viatical settlements, the possibility of extending the life of the viator increases the risk of the investment, and may thus decrease the

amount investors are willing to pay for policies. *See* Sommer et al, *supra* note 6, at 57.

However, some estimate of the viator's life expectancy must be used to calculate the purchase price of a policy. Therefore, even before protease inhibitors began increasing the life expectancies of some AIDS patients, estimating the life expectancy of a particular viator was challenging. This estimation is critical to the pricing of the transaction; the shorter the life expectancy of the policyholder, the greater the percentage of the policy value paid. If the viator died earlier than, or outlived, the projected life expectancy used to calculate the viatical settlement payment, the return to the investor is affected.

This risk is very real. In one case, an Arizona man invested over $100,000 in 21 policies on the lives of viators who were predicted to die within the following two years. Three years later, only seven had died, and the investor was told he would have to pay the premiums or lose his entire investment in those policies. *See* Marcia Vickers, *Investing It: For Death Futures, the Playing Field Is Slippery*, N.Y. TIMES, Apr. 27, 1997, § 3, at 5. So the viator's longevity decreases the ultimate return when the death payments are finally paid, and in a more immediate sense, increases the out-of-pocket costs to the investor, who must assume responsibility for ongoing policy premiums after the first two years. *See* Sommer et al., *supra* note 6, at 55, for a tabular illustration of the range of expected returns for varying lengths of time and initial investment; *see also* Deeley, *supra* note 12, at 386.

Viatical settlements also pose legal risks to the investors. Although no court has done so yet, a judicial determination that the viator lacked the necessary mental capacity to enter into the viatical settlement, or that the decision was made under duress, could force an equitable recision of the viatication contract. There is also the possibility that a court would hold the policy to be non-assignable or cancelable, or that not all the prior beneficiaries would have waived their rights, if irrevocable, under the policy. Likewise, a court could find a state's incontestability statute inapplicable, thereby allowing the issuing life insurance company to rescind the policy. For a discussion of incontestability clauses and their effect on the viatical settlement industry, *see infra* Part II.

Finally, because of the nature of the viatical settlement transaction, the insurance company that issued the original policy provides the ultimate credit for the transaction, exposing both the viator and the viatical settlement firm to the risk that the insurance company will default on its payment obligations. *See* Eremia, *supra* note 9, at 783.

Because viatical settlements are such a new type of transaction, courts have not yet considered issues common in traditional insurance litigation, such as lack of capacity or duress. Further, there are, as of yet, no cases of issuing insurance companies defaulting on viatical settlement transactions. However, as more policies are viaticated, and in the absence of appropriate regulation, the likelihood of such an occurrence increases. There have been cases of the issuing insurance company failing to pay, however. In such cases, there typically has been an allegation of fraud. *See infra* Part II for a discussion of the fraud problems in the viatical settlement industry.

See Thomas Hammack, *Regulating Viatical Transactions*, 45 FED'N INS. & CORP. COUNS. Q. 85, at 103 (1994), for a discussion of unequal bargaining power, duress, mistake, and incapacity in contracts made between a viatical settlement company and the terminally ill, concluding that, because the insured is often not in the position to bring a claim after the contract has been entered because of his or is insufficient. The risks present in the viatical settlement industry mandate that some form of disclosure be required to protect investors so as to maintain or even expand the number of investors in their critical role as supplier of funds in the viatication process. Those opposed to regulating the sale side of the viatical settlement industry might argue that these risks are self-evident, and that a savvy investor ought to be able to protect himself or herself contractually from any resulting exposure.[40] However, viatical settlements are a relatively new type of transaction, and participants are not limited to financially sophisticated or accredited investors.[41] Viatical settlements have a humanitarian component that may attract first-time, unsophisticated investors who need information about the risks of viatication. In addition, the increasing costs of treating AIDS means that viators need investors to buy their policies more than ever.[42] This combination increases the need for the disclosure and antifraud protections of the Securities Laws.

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her health, "paternalistic regulation is necessary to prevent the abuse from occurring, and to ensure economic efficiency and distributive justice, personal integrity, and sound judgment."

40. As the viatical settlement market matures and responds to a changing landscape, new risks are identified, and, because of the lack of protection under state or federal securities laws, new innovations must be created to manage the risks. For example, as a hedge against the risk that the viator will outlive his or her projected life expectancy, thereby reducing the investors' return, some viatical settlement companies are using supplemental insurance policies to provide interim payments to investors. Several U.S. viatical settlement companies and one U.K. viatical settlement company teamed up to offer a product called "ProfitShield" under which investors can purchase the insurance through their viatical settlement company on invested capital. The program has a one-year deferment following maturity and will provide a maximum coverage of two years to death. The investor receives the benefit of the insurance plus the actual death benefit under the policy when the insured dies. *See* Barbara Mannino, *Moving Beyond the Learning Curve: Emergence of Viatical Insurance Settlements*, BEST'S REV. - LIFE-HEALTH INS. ED., Aug., 1997, at 72.

41. *See* Michael R. Davis, *Unregulated Investment in Certain Death: SEC v. Life Partners*, 42 VILL. L. REV. 925, 926-27 (1997).

42. Before the advent of costly protease inhibitors, the proceeds of the first viatical settlements tended to be used by patients to pay medical and other bills, and grant last wishes. *See* Kara Swisher, *Allstate to Offer Discounts to Buy Policies of the Terminally Ill*, WASH. POST, Aug. 1, 1991, at B8. This use of funds may have been simply a function of the lack of any meaningful life-prolonging treatments available at that time. Now the new protease inhibitors are available and, for many patients, are proving helpful in reducing their viral load down below detectable levels, with the potential for corresponding reductions in HIV opportunistic infections. *See* Sommer et al., *supra* note 5, at 56-57.

As the viatical settlement industry grows to include viators with conditions other than AIDS, there is a corresponding increase in the need for disclosure to investors. In the continued absence of federal regulation, the threat of fraud remains, potentially leading to the absence of investors. As a result, the viatical settlement market would consist only of the few companies or individuals who would agree to buy a policy and hold it themselves until it matures. Investors must be provided with adequate disclosure to eliminate, or at least minimize, fraud, both to investors and viators. However, since the only existing regulation of viatical settlements occurs at the state level, in order to protect viators, the protection of investors through federal regulation becomes paramount.

II: Ethical Considerations in the Viatical Settlement Industry

While viatical settlements are legal, the moral aspects of viatication are less clear.[43] The current regulation of viatical settlements ignores investors' needs. Instead, the regulations protect viators from unscrupulous viatical settlement firms that may seek to take advantage of viators.[44] Courts have not yet applied traditional contract defenses like duress, undue influence, and lack of capacity, but as the viatical settlement industry continues to grow, this is likely to change.[45]

AIDS has always been a very expensive disease, and with the advent of the protease inhibitors, the cost of fighting it has gone up dramatically. "[S]ince protease inhibitors do not help everyone and can cost as much as $20,000 per year to administer, HIV/AIDS patients may still be in need of medical funds since most health insurance plans limit medication reimbursement as well as medications to those included on a specific approved list." *See* Eremia, *supra* note 9, at 787; *see also* Sommer et al., *supra* note 6, at 57; *see also* Lang, *supra*, note 31, at 10.

43. *See* Osborne, *supra* note 10, at 485-90.

44. *See supra* note 13 for a list of the current state statutes and proposed legislation of viatical settlements.

45. Traditional contract law principles dealing with lack of capacity provide one sort of remedy for viators. A party lacking contractual capacity enters into a contract that is voidable at the incompetent party's option. However, because of the peculiar circumstances of terminally-ill viators, contract law remedies may be insufficient. Terminally ill parties may not realize or be able to face their own incapacity, and further, might not seek to spend any of their precious remaining time on litigation. *See* Crites-Leoni & Chen, *supra* note 9, at 80-81; *see also* Hammack, *supra* note 39, at 103.

Viatical settlements are not the only enterprise to profit from the dying. Death is its own industry, encompassing hospitals, hospices, physicians, home care attendants, pharmaceutical companies and funeral homes. These participants are not generally considered ghoulish; yet there is a stigma attached to viatical settlements, perhaps because of the more direct connection between profit and death.

Viatical settlements are not for the squeamish. The return on the investment does not depend on the performance of anonymous workers in a competitive market; it depends on how long a terminally-ill human being lives.[46] The investor, and the viatical settlement firm, while sympathetic to the viator's medical condition, hope, at least from a financial point of view, that the viator does not live out his or her life expectancy.

The unsettling ethical aspects of viatical settlements can be offset by the corresponding moral good in helping the dying. The tension involved with viatical settlements stems from the inexorable linking of the benevolent and the financial incentives. If investors do not earn a decent, if not superior, rate of return, they will move their investment funds into other vehicles.

Perhaps with these concerns in mind, many of the state regulations on viatical settlements require that the viatical settlement firm obtain a medical certification as to the viator's mental capacity. *See* ARK. CODE ANN. § 23-81-509(A)(1) ("A viatical settlement provider entering into a viatical settlement contract with any person with a terminal illness or condition shall first obtain [ ] a written statement from a licensed attending physician that the person is of sound mind and under no constraint or undue influence."); *see also* CODE ME. R. § 24-A at 6809 (1997). Arguably, ethical viatical settlement firms would require this of their own accord.

46. "The financial risk in viaticals creates a morally perverse feature not present in other investments: the investor must hope for the early demise of the person whose life insurance he buys. The longer the person hangs on, the lower the annual rate of return." Michael J. Sandel, *You Bet Your Life*, NEW REPUBLIC, Sept. 7, 1998, at 11.

Promotional materials from one viatical settlement firm listed T-cell counts of twelve viators, along with their names, medical summaries, life expectancies and the rates of return on their policies. The viatical settlement firm was prominently featuring one particular viator, with a T-cell count of 150 per cubic milliliter of blood, compared with a normal level of about 1,000. In the words of the company, this viator was suffering from "Thrush, Kaposi's Sarcoma, Hairy Leukoplakia! Peripheral Hyperesthesia!" The company promised the viator wouldn't live more than 15 months. *See* Allen, *supra* note 24, at W13.

Beyond the legalities of viatical settlements are complex ethical issues.[47] These issues fall into three categories: conflicts of interest, confidentiality concerns, and fraud.[48] These categories constitute the primary areas where disclosure to investors is needed to permit informed investment decisions. Even though conflicts of interest, confidentiality concerns, and some forms of fraud can be adequately addressed by state regulation on the purchase side of viatical settlements, the more threatening aspects of fraud in the viatical settlement industry are best addressed by bringing viatical settlements under the protection of the Securities Laws. Investors need disclosure on these issues, whether such issues are handled by state or federal regulation, or no regulation at all. The following discussion explores these issues in their context as subjects for disclosure pursuant to the Securities Laws.

A. *Conflicts of Interest*

The viatical settlement industry is subject to conflict of interest problems that pit the agendas of others against what may truly be in a viator's best interest. Because of the expense of the new protease inhibitors, funds for life-sustaining care are coming from investors with a very real stake in seeing the viator's life end sooner rather than later. Viatical settlement firms are in the business of making money, so they aim to find viators who will predecease their life expectancy. While predicting life expectancies is not an exact science, the evaluation of a viatical application includes an examination of the quality of the viator's medical care; the lower the quality of care, the more quickly the viator is likely to die.[49] Viatical firms have strong financial incentives to discourage or prevent viators from par-

47. *See* Crites-Leoni & Chen, *supra* note 9, at 78.

48. *U.S. News & World Report* conducted a study of the viatical settlement industry in the mid 1990's and "uncovered a darker side of the business, marked by conflicts of interest, lack of disclosure and nonexistent or ineffectual regulation. Health care providers, lawyers and financial planners who work with the terminally ill may benefit without the knowledge of their patients or clients. Brokers who claim to find the best terms for sellers actually work for the companies that buy the policies." Pamela Sherrid, *Enriching the Final Days*, U.S. NEWS & WORLD REP., Aug. 21, 1995, at 56.

49. According to one infectious disease specialist paid by a viatical settlement firm to evaluate medical records, "it's morally distressing work, like watching from a window as a pedestrian heads for an open manhole. But I can't call up a doctor I

ticipating in experimental or life-prolonging therapies.[50] Likewise, a nursing home or other care facility that is paid more by private patients than by Medicaid has a strong financial incentive to pressure patients to viaticate policies, even when the viatication serves the facility's best interest, and not necessarily that of the viator.[51]

The clearest potential conflict of interest in the viatical settlement industry arises when health professionals and care providers ally themselves with viatical settlement firms. The concern stems from a caregiver who becomes financially linked to a venture that ultimately benefits from the viator's death, with the size of such benefit inversely related to the length of the viator's life.[52] The underlying issue is whether it is morally sound, or even appropriate, for a facility providing services to AIDS patients to ally itself with a venture profiting from the death of its patients.[53]

The conflict arises on an enterprise-wide level, in relationships between health care facilities and viatical settlement firms,[54] and on an individual level, between one health care

don't even know and say 'You don't know what you're doing.'" Allen, *supra* note 24, at W13.

50. *See* Crites-Leoni & Chen, *supra* note 9, at 78.

51. *See* Sherrid, *supra* note 48, at 56

52. *See id.*

53. *See* Philip P. Pan, *D.C. AIDS Clinic Makes Deal with Insurance Buyer: Critics Question Arrangement of Payments to Whitman-Walker*, WASH. POST, Sept. 11, 1995, at A01.

54. In 1995, the Whitman-Walker Clinic, Washington, D.C.'s then largest provider of AIDS services, entered into an alliance with Life Entitlements Corp., a New York viatical settlement firm. *See id.; see also* Sherrid, *supra* note 48, at 56. The clinic received three percent of the face value of policies purchased by Life Entitlements from viators within a 100-mile radius of Washington; the clinic also gave permission for Life Entitlements to use the clinic's name in its promotional materials. *See* Pan, *supra* note 53, at A01. The clinic was apparently in dire financial straits, which this alliance would no doubt ease. The viatical settlement firm gained the opportunity to piggy-back onto a respected medical establishment, increasing its own reputation. *See id.*

Officials at the clinic stressed that the alliance was in no way an endorsement of Life Entitlements, and that the clinic would receive its percentage regardless of whether a given viator was a clinic patient. *See* Sherrid, *supra* note 48, at 56. The executive director of the clinic characterized the relationship as strictly donor and recipient. While the clinic would single out Life Entitlements, it would be singled out as the only firm donating money to the clinic. The clinic would advise its clients to get bids from other firms, a list of which it claimed to provide to clients. *See* Pan, *supra* note 53, at A01. Although the clinic brochure on viatical settlements worker and one viatical settlement firm.[55] Some viatical settlement firms have begun offering their services directly to hospitals,[56] and some physicians have requested direct commissions for referring viators to viatical settlement firms.[57]

The specter of conflict of interests in the viatical settlement industry has lessened somewhat over time, in part because states,[58] and viatical settlement industry trade groups,[59] have begun to legislate codes of conduct aimed at reducing the potential for conflicts, and in part because, as the industry grows and becomes more mainstream, viators and their advocates become more educated about viatication in general, and become more aware of these potential conflicts. Nonetheless, the potential for these conflicts of interest must be disclosed to viatical settle-

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advised potential viators to shop their policies around to multiple viatical settlement firms, Life Entitlement's logo was prominently displayed in the brochure, and in fact, Life Entitlements was the only viatical settlement firm mentioned by name, along with its toll-free telephone number. *See* Sherrid, *supra* note 48, at 56.

55. At AIDS Foundation Houston, a nonprofit AIDS support organization, a supervising social worker moonlighted as a representative of a viatical settlement firm. The facility's executive director knew of the arrangement, but justified it because the social worker was not allowed to promote her viatical settlement firm at the facility, and because the majority of the facility's clients were too poor to have life insurance to viaticate. To ease this conflict, the viatical settlement firm agreed not to display brochures at the facility's group offices and had its name deleted from the list of recommended viatical settlement firms distributed by the facility. *See* Sherrid, *supra* note 48, at 56.

56. Viaticus, Inc. sent representatives to hospitals to sell the benefits of viatical settlements to health care providers, such as case workers. *See* Allen, *supra* note 24, at W13. Viaticus was, in effect, asking hospital personnel to serve as its unpaid salesmen. However, case workers are supposed to "steer patients through the maze of care options while helping their hospital survive in the cutthroat world of contemporary medicine" and not steer them toward the particular option of viatication, or to a particular viatical settlement firm. The conflict arises in that, by convincing patients to viaticate, the patients get an influx of cash to pay debts, presumably including debts owed to the case workers' employer, the treating hospital. *See id.*

57. *See* Sherrid, *supra* note 48, at 56.

58. *See* CAL. INS. CODE § 10113.2(f) (West 1997).

59. Viatical settlement industry trade groups have adopted codes of conduct for their member firms. Members of the NVA must adhere to stated "Standard Business Practices" and "Code of Ethics." *See* NAT'L VIATICAL ASS'N INFO. BOOKLET, 15-16.

According to the Viatical Association of America ("VAA"), another industry trade group, it is "dedicated to the maintenance of high ethical standards, including absolute respect of viator privacy and confidentiality. We promote the highest level of professionalism by our members and full compliance with state laws." *Id.*

ment investors in order for them to make informed investment decisions.

B. *Confidentiality*

Another problem burdening the viatical settlement industry flows from the tension between protecting viators' privacy regarding the details of their illness, and providing viatical settlement firms with that same information which is critical to appropriately pricing the policies. In most viatical settlements, the viator releases his or her medical records to the viatical settlement company. This release may contain a confidentiality provision, but at least some of the viator's specific medical history will need to be disseminated to potential investors as part of the necessary, albeit, macabre, marketing of the policy.[60]

This tension has been eased through the efforts of the National Association of Insurance Commissioners ("NAIC").[61] The NAIC Viatical Settlements Working Group drafted a Viatical Settlements Model Act and Regulation, which serve as the basis for most of the state regulation of viatical settlements.[62]

Some regulators fear that the current state laws do not provide sufficient protection to viators.[63] Of the states that regulate viatical settlements, only Maine prohibits the release of the viator's personal information.[64] However, even without being

60. Allen, *supra* note 24, at W13; *see also* Treaster, *supra* note 35, § 3, at 1.

61. The NAIC is a voluntary association made up of the chief insurance regulatory commissioners and staff from all 50 states, the District of Columbia and American Samoa, Guam, Puerto Rico, and the U.S. Virgin Islands.

62. In December 1993, the NAIC adopted the "Viatical Settlement Model Act" and in September 1994, the NAIC adopted the "Viatical Settlement Model Regulation" (collectively, the "NAIC Models"), designed to protect viators when dealing with viatical settlement companies. The three primary areas of regulation in the NAIC Models are enforcement provisions, mandatory disclosure to viators, and mandated minimum payouts. *See* 1994-1 NAIC Proc. 352, 362.

63. Tom Foley, Commissioner of the North Dakota Insurance Department, wants to protect viators from any possible physical risk stemming from the release of their personal information, including names and addresses. Mr. Foley led an effort at the NAIC's 1998 spring meeting to adopt a model regulation that prohibited viatical brokers from revealing the names of viators to investors. *See NAIC Mulls Privacy Option on Viaticals*, AM. BANKER-BOND BUYER, Apr. 6, 1998, at 1 [hereinafter *NAIC Mulls Option*].

64. *See* CODE ME. R. § 24-A at 6806 (1997); *see also NAIC Mulls Option*, supra note 63, at 1.

legally prohibited, some viatical settlement companies decline to release this information as a policy matter.[65]

In 1998, the NAIC Viatical Settlement Working Group again took up the issue of confidentiality, discussing the possibility of including some privacy language in the Model Regulation.[66] If the NAIC includes language to combat this problem, the states may be inspired to adopt the language into their own statutes. This approach would ease the confidentiality problem, by granting viators needed additional protection, while still allowing viatical settlement firms to disclose the information necessary to sell the policies. However, increasing viator protection, and even providing remedies for violations of such protection, increases the need for disclosure to viatical investors who might be pulled into such remedy.[67]

C. *Fraud*

The third and most pervasive ethical concern in the viatical settlement industry is the threat of fraud. The rapid growth and increasing legitimacy of viatical settlements as investments have created a corresponding possibility of fraud on or by viatical settlement participants that, if unchecked, could ultimately cripple this industry. The expense of fighting a terminal illness may tempt some viators to commit fraud. Viatical settlements permit viators access to funds to pay for life-prolonging treatments, but only if there is a valid underlying insurance policy. Thus, viators have every incentive to secure life insurance,[68] even when they know they are HIV-positive.[69] Likewise, un-

65. *See NAIC Mulls Option, supra* note 63, at 1.

66. *See NAIC Mulls Option, supra* note 63, at 1.

67. *Life Partners* raised concerns about the effect of the Securities Laws' disclosure rules on the privacy of viators. The district court characterized this as a false concern, because the disclosure obligations fall only on those "selling or offering securities, not on those selling assets which are then repackaged by others as securities." SEC v. Life Partners, Inc., 898 F. Supp. 14, 19 (D.D.C. 1995).

68. "The development of these drugs and drug regimens [(protease inhibitors)] may increase antiselection risks because unscrupulous individuals might view life insurance as an opportunity to pay for the drugs and other medical care. Any such funding would be borne indirectly by healthy individuals in the form of higher premiums." George B. Kozol, *Home HIV Tests Create New Problems: Some May Fraudulently Purchase Life Insurance to Fund Medical Care*, BEST'S REV. - LIFE-HEALTH INS. ED., Dec. 1996, at 68.

69. Disclosure of HIV-positive status is no longer a total bar to obtaining life insurance. An insurance company recently began marketing insurance for HIV-

scrupulous viatical settlement firms may try to sell non-existent policies to investors who are unprotected by the disclosure requirements of the Securities Laws.

Fraudulent practices have been documented in the viator's purchase of the underlying policy from the issuing insurance company, and on both the purchase and sale side of the viatical settlement industry. These fraudulent practices fall into four basic scenarios: (1) unscrupulous insurance agents assisting viators in defrauding insurance companies by keeping the viators' HIV status secret; (2) viators defrauding insurance companies on their own, relying on traditional insurance law incontestability clauses;[70] (3) viators defrauding viatical settlement companies; and (4) viatical settlement companies defrauding viators and investors.

The potential for fraud perpetrated by viators and insurance agents pales in comparison to the potential for fraud perpetrated on investors by unscrupulous viatical settlement firms. Moreover, unlike the fraud by viators and insurance agents, which are somewhat controlled by state regulation, there is essentially no regulation in place to curb the potential fraud by viatical settlement firms, other than a common law action for fraud.

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positive applicants. *See supra,* note 29. However, the vast majority of insurers decline to provide new policies for applicants whom it knows to be HIV-positive, creating an incentive for unethical viators to hide their HIV status:

> For the first time the life insurance industry faces a situation in which an individual can reap significant financial rewards from a fraudulent life insurance application. For instance, someone who knows he is seriously ill at the time of his application can intentionally misrepresent his health and medical history to obtain a life insurance policy. The person who survives the two-year contestability period can then obtain a substantial percentage of the policy face amount from a viatical settlement company.

Kozol, *supra* note 68, at 68.

70. An incontestability period represents the agreement that an insurer will not dispute the validity of the policy after the expiration of some fixed time, typically two years, from the date of the policy. *See* Burke A. Christensen, *Incontestable Clause Gives Insurance Fraud New Meaning*, TRUSTS & ESTATES, Apr., 1997, at 68. The purpose is to protect beneficiaries from unnecessary litigation after the insured dies. *See* Eric K. Fosaaen, *AIDS and the Incontestability Clause*, 272 N.D. L. REV. 267, 271 (1990). Any application for an increase in the dollar amount of insurance coverage starts the incontestability period over again with respect to such increase. *See also* Dignity Viatical Settlement Partners v. Cedalion Systems, Inc., 4 F. Supp. 2d 466 (W.D.N.C. 1998).

1. *Insurance Agents Defrauding Insurance Companies*

The first scenario, agents defrauding their insurance companies, arises because insurance agents make money selling the policies that underlie viatical settlements. Therefore, they have an incentive to sell as many policies as possible. When the policies are correctly priced and issued, based on full disclosure by the applicant of all relevant risks, including the health of the applicant, the insurance company bears only the risk it agreed to assume, for a price it deemed adequate compensation for such risk. However, when insurance agents grant viators fraudulent access to life insurance coverage, the insurance industry, and, to a certain extent, innocent participants in the insurance and viatical settlement industries, also pay the price.[71] These unethical agents give viators insurance coverage that would be unavailable if the issuing company knew of their health situation. Further, the agents give viators at least the possibility of access to the corresponding death benefits through viatication.[72] This fraudulent behavior increases the costs of both issuing and viaticating policies, and thus decreases the profits for both insurance companies and viatical settlement firms, and may cause existing viatical firms to leave the industry, or potential new firms to avoid the industry.[73]

Unscrupulous insurance agents certainly contribute to this form of fraud, but they are not solely to blame. Insurance industry participants argue that the insurance applications are

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71. *See* Fosaaen, *supra* note 70, at 294.

72. *See* Charles E. Schmidt, Jr., *Shady Agent, Viatical Mix Creates Recipe for Fraud*, BEST'S REV. - LIFE-HEALTH INSUR. ED., Mar. 1996, at 68.

73. According to insurance industry participants, life insurance is not priced to finance medical treatment:

> Life insurance pricing is based on mortality risks, not morbidity risks. The goal of underwriting is to categorize individual risks based on recognized actuarial criteria. In general, standard risks are those individuals who, based on health and medical history, are projected to have the same average life expectancy as individuals the same age. Rated risks are individuals who are placed in a group projected to have a shorter-than-average life expectancy, typically because of health impairment or medical incident. Rated risks are charged a higher price than standard risks for similar life insurance coverage, commensurate with the greater mortality risk their group presents.

Kozol, *supra* note 68, at 68.

inadequate for screening out HIV-positive applicants.[74] Insurance agents therefore must rely on the incontestability period,[75] and the sometimes-questionable ethics of applicants and agents for protection.[76] Some agents are proud to help HIV-positive applicants secure life insurance by misleading the issuing company, to whom the agent owes various legal duties, including a duty of loyalty.[77] If the application asks whether the applicant has AIDS, but is not specific enough to pick up an HIV-positive applicant who has not developed full-blown AIDS, agents can counsel applicants so that their answers are literally true, yet misleading, or they can counsel the viators to lie, or to sanitize medical records to eliminate references to HIV status, all in an effort to "help" the viator by securing life insurance.

One way to eliminate this type of fraud would be for all states to legislate that any knowledge on the part of the agent about the applicant is deemed to be imputed to the insurance company.[78] This would prompt the insurance industry to create application materials and procedures designed to uncover the applicants' true health status, and would hold the insurance agents directly liable for their fraud.[79]

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74. Insurance industry participants find the standardized medical questionnaire used by insurance companies problematic. Under some state laws, any knowledge on the part of the agent selling the policy is deemed to be imputed to the insurer. So if the agent learns of adverse medical information regarding an applicant, not listed on the application, it is as if the insurer actually learned of it. *See* Kozol, *supra* note 68, at 68; *see also Small Life Insurers Warned of HIV Exposure*, BESTWIRE, Oct. 18, 1995 [hereinafter *Small Life Insurers*].

75. *See infra* notes 81-100 & accompanying text for a discussion of incontestability clauses.

76. *See Small Life Insurers*, *supra* note 74.

77. *See* Schmidt, *supra* note 72 at 68.

78. Arizona, Kentucky and Oregon attribute to the insurer the knowledge of the agent about an applicant's medical history. As a result, lawsuits in those states arising out of undisclosed medical facts usually include the agent as a defendant, along with the insured. On the other hand, New York, Maryland, and Washington rarely impute information that is unrevealed on the application to the agent. In Wisconsin, insurers are prohibited from voiding a policy if the selling agent was aware of the applicant's health status when the policy was issued. *See* Schmidt *supra* note 72, at 68; *see also Small Life Insurers*, *supra* note 74.

Because the concept of imputed knowledge is not the law in all states, insurance companies must change their standards on medical questionnaires, depending on the state law. *See* Kozol, *supra* note 68, at 68.

79. Insurance companies have the power to correct this imbalance on their own.

2. *Viator Fraud on Insurance Companies*

The second scenario, viators defrauding insurance companies without the knowledge of the agents,[80] centers on the protection of the incontestability clause.[81] In this scenario, the applicant misstates his or her HIV status when applying for insurance coverage.[82] An incontestability clause operates like a statute of limitations for the issuing insurance company, limiting the permissible time period to investigate fraud and other abuses that would otherwise void coverage. The clauses are simply a mechanism for sharing risk.[83] The insurance company has the entire incontestability period, typically two years, to ascertain any improprieties about the applicant, the application, or anything else relating to the policy.[84] Typically, the expiration of an incontestability clause is deemed to remove all misstatements, including fraud, as grounds for denying coverage; so unless the incontestability clause provides a judicially-recog-

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> Insurers can protect themselves further by monitoring policy assignments in favor of viatical settlement societies and tracking them by agent and agency. The insurer might routinely scrutinize medical questionnaires submitted with the application for these policies. In an instance where an insurer discovers a number of suspicious applications submitted by a particular agent or agency, the insurer should investigate each one to determine whether impostors were used to avoid underwriting screens. This activity amounts to criminal fraud on the part of the agent and the agency, and would subject the perpetrator to criminal and monetary sanctions.

Kozol, *supra* note 68, at 68.

80. According to one viatical settlement industry participant, viatical settlements undertaken by AIDS patients are ripe for fraud because, prior to the AIDS epidemic, there were very few terminal conditions that lasted longer than the two-year incontestability period. Thus, a fraudulent applicant would most likely die during the incontestability period, thereby preserving the company's right to deny payment based on fraud. However, HIV-positive applicants may well outlive the two-year incontestability period. *See* Schmidt, *supra* note 72, at 68.

81. For a detailed discussion of incontestability clauses, *see generally* Katherine Cooper, Note, *Liar's Poker: The Effect of Incontestability Clauses After Paul Revere Life Insurance Co. v. Haas*, 1 CONN. INS. L.J. 225 (1995).

82. *See* Fosaaen, *supra* note 70, at 287.

83. *See* Cynthia Koehler, *Incontestability Laws Abet Fraud by Applicants and 'Materiality' Restricts the Right to Rescind*, NAT'L L. J., Sept. 8, 1997, at C12; *see also* Cooper, *supra* note 81, at 226.

84. The insurer must pay out on the policy even if it learns that the "insured was terminally ill at the time of the application, knew he was terminally ill, and intentionally misrepresented his health circumstances and medical history in responding to questions posed by the agent or medical interviewer." *See* Kozol, *supra* note 68, at 68.

nized exception for fraud, the insurer can only raise a fraud defense prior to the expiration of the incontestability period.[85] Thereafter, with several statutorily-created exceptions,[86] the insurance company must pay on the policy when the insured dies.

Insurance industry participants would like to see incontestability periods eliminated entirely, as they drastically limit the protection available to insurers.[87] At a minimum, the industry would like to see these periods extended, to help reconcile the incontestability period with the latency period that can exist before an insured develops AIDS.[88] However, these incontestability periods serve a valid function and should not be eliminated.[89] They simply require the insurance industry to take a

85. *See* Cooper, *supra* note 81, at 228. Some courts have said that even if the policy language does contain such an exclusion for fraud, the exclusion may be invalid.

> Although there have been a few cases to the contrary, the general rule has long been that even the defense of fraud is barred by the incontestable clause. Few states permit insurers to insert fraud as an exception to the incontestable clause. Until recently, however, the courts permitted insurers to deny claims based upon the fraudulent acts of the applicant if the fraud was of a very serious type. Examples of serious fraud are policies procured with an intent to murder the insured or when the insured sends a substitute to apply for the policy and take the medical exam.

Christensen, *supra* note 70, at 68; *see* Koehler, *supra* note 83, at C12; *see also* United Fidelity Life Ins. Co. v. Emert, 49 Cal. App. 4th 941 (4th Dist. 1997) (affirming the continuing application of incontestability clauses to fraud claims); *infra* note 99 for a discussion of the *Protective Life* case.

86. Exceptions include matters such as "non-payment of premiums or violation of the conditions of the policy relating to military or naval service in time of war and except, if the company so elects, for the purpose of contesting claims for total and permanent disability benefits or additional benefits specifically granted in case of death or accident." Protective Life Ins. Co. v. Sullivan, 89 F.3d 1, 2 (1st Cir. 1996) (citing Mass. Gen. L. ch. 175 § 132).

87. *See Small Life Insurers*, *supra* note 74.

88. "Given an average latency period of four years for AIDS, coupled with legislative prohibitions against insurance-related testing, it becomes relatively simple for an individual with knowledge of his or her infected status to make misrepresentations regarding such knowledge with reasonable assurance that the incontestability period will expire before "suspicious" symptoms appear that alert the insurer to the possibility that misrepresentation has occurred." Clifford & Iuculano, *supra* note 4, at 1819; *see also* Fosaaen, *supra* note 70, at 287.

89. Incontestability clauses are required in life, health and disability insurance policies in most states, for public policy reasons, to "encourage consumer confidence and reduce insurer contests to the policies based on information given in the application form." Cooper, *supra* note 81, at 225. Incontestability clauses aid dishonest people whose dishonesty is not discovered during the period. However, these clauses also give insured persons piece of mind and eliminate the possibility

more proactive and prompt approach to protecting its own interests.

The incontestability clause framework, coupled with the advent of home testing for HIV status,[90] increases the potential for fraud by unscrupulous HIV-infected viators.[91] Viators could sign up with many different life insurance companies, purchasing small policies that typically do not trigger intense scrutiny such as blood testing for HIV.[92] The viators could then hold the policies beyond the incontestability period and viaticate the policies, defrauding either the viatical settlement company, if the

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of an insured paying premiums for years, only to have the insurance company suddenly notice a problem with the policy and deny a claim when the necessary evidence to dispute the denial of the claim may no longer be available. *See* Christensen, *supra* note 70, at 68.

90. In May 1996, the Food and Drug Administration approved a home HIV test.

> The test offers more privacy and anonymity than a visit to a doctor's office. The kit can be purchased at drugstores without a prescription. The user pricks his or her finger with the kit's lancet and places blood droplets on a test card bearing an identification number. The card is mailed to a laboratory for HIV testing; samples that test positive are retested. A week later, the individual obtains test results via phone punching in his or her identification number.

Kozol, *supra* note 68, at 68. These tests are now available nationwide, providing anonymous HIV testing. As a result, viators can apply for insurance, knowing and not disclosing their HIV status. Insurers have options; they can require blood tests for all applicants, regardless of the applicant's presentation or the face value of policy sought. *See* Kozol, *supra* note 68, at 68.

91. "Because the fear of an AIDS epidemic is very real for certain groups in our society, applicants for life insurance who believe they have been infected with the virus very well may misrepresent their health history or their present physical conditions when applying for coverage. These misrepresentations would normally be grounds for recision of the policy; however, after the time period in an incontestability period has passed, benefits cannot be denied on the ground that ill health or physical disability existed at the time the policy was issued." Clifford & Iuculano, *supra* note 4, at 1819.

92. *See Small Life Insurers*, *supra* note 74. The legality of requiring such blood tests has been questioned. Until the mid-1980s, the right of an insurance company to test for any condition affecting mortality or morbidity was generally accepted both within and outside the insurance industry. States began to pass laws in the mid 1980s, presumably to prevent discrimination against homosexuals, that "substantially impede[d] the insurance industry's ability to assess risk, thereby undercutting the industry's financial stability and compromising its ability to pay future claims." Clifford & Iuculano, *supra* note 4, at 1815; *see* WIS. STAT. ANN. § 631.90 (West Supp. 1986) (prohibiting insurance companies from even asking applicants if they have been tested for HIV).

policy was not yet resold, or the investors who purchased interests in the policy.[93]

Because HIV-positive individuals can remain asymptomatic for years, insurers have begun to require blood tests to supplement the medical questionnaire and examination, even for younger applicants or those seeking small face value policies.[94] HIV-positive viators have a strong incentive to avoid these blood tests.[95] This form of fraud is especially problematic for insurers in states that do not recognize an exemption to the incontestability period for impostor situations.[96] In states that recognize such an exemption, if the specimen provided for an insured is proven to be from someone else, the insurance company can refuse to pay on the policy, or rescind the policy.[97] Two egregious examples of this type of fraud are the California case of *Amex Life Assur. Co. v. Superior Court*,[98] and

93. Another possibility is that viators could purchase many small policies, and viaticate the policies before the expiration of the two year incontestability period, if they could find a willing viatical settlement firm. Then, if the insurance company voided the policy for fraud, the viatical settlement firm or its investors would be stuck. This scenario does not present a great potential for fraud because most viatical settlement companies are now savvy enough to know the relevant state laws on incontestability, and tend not to purchase policies until they have been held for more than such period. *See NAIC Mulls Option*, *supra* note 63, at 1.

94. "In response to the new home-based anonymous HIV tests, many insurers will find it necessary to and claim-processing practices in order to protect the integrity of life insurance pricing and underwriting. Recent developments in HIV testing and drug therapies will intensify the unique "antiselection" risks that life insurers face as a result of the AIDS crisis and burgeoning viatical settlement business. Some life insurers may experience severe financial problems as a consequence of this elevated antiselection activity. Antiselection occurs when those most at risk are most likely to seek a particular type of coverage. But, life insurers have some options — short of imposing blood tests for all insurance applicants - to combat this." Kozol, *supra* note 68, at 68. For a discussion of the issues surrounding AIDS testing for insurance applicants, *see generally* Clifford & Iuculano, *supra* note 4.

95. *See* Kozol, *supra* note 68, at 68.

96. *See infra* note 99 for a discussion of the legal result when an applicant for life insurance sends an impostor to take a required medical exam or blood tests.

97. Insurers can use this impostor safe-harbor to carefully examine claims submitted on policies that are beyond the contestable period, especially those submitted under policies being viaticated. *See* Kozol, *supra* note 68, at 68.

98. In *Amex Life Assur. Co. v. Superior Court*, 14 Cal. 4th 1231(1997), Jose Morales knowingly misrepresented his HIV status when applying for life insurance from Amex in January, 1991, and sent someone four inches taller and 30 pounds heavier than he to take the required medical examination. *See Amex Life Assur.*, 14 Cal. 4th at 1234. Amex personnel failed to notice these discrepancies

the Massachusetts case of *Protective Life Ins. Co. v. Sullivan*.[99]

and on May 1, 1991, issued a policy to Mr. Morales, with an incontestability clause barring Amex from contesting coverage under the policy, except for non-payment of premiums, after the policy had remained in effect for two years. *See id.* at 1233-34. Mr. Morales paid all the premiums on the policy, and just before he died on June 11, 1993, he sold his policy to Slome Capital, a viatical settlement firm. *See id.* at 1235.

Amex denied payment for fraud when it learned of the impostor situation. Slome Capital, the beneficiary of record, sued Amex for breach of contract, insurance bad faith and equitable estoppel, relying on the validity of the incontestability clause. *See id.* at 1235. Amex tried to get the court to adopt an "impostor" defense, which was characterized as a defense where "a person applies for a life insurance policy and takes the medical examination but names another person as the insured, the policy does not insure the named person but, if anyone, the person who completed the application and took the examination." *Id.* at 1235-36. According to Amex, under the impostor defense, Morales' coverage was void from the policy's inception, thus the incontestability clause was inapplicable. *See Amex*, 14 Cal. 4th at 1242.

The California Supreme Court was unpersuaded and affirmed the Court of Appeals decision for Slome Capital. *See id.* at 1246. As a policy matter, this fraud and the ensuing litigation could have been avoided if Amex had simply required the person taking the medical examination to produce a verifiable photo identification. Amex did not dispute that it had the information about the appearance of the impostor from the time it issued the policy. *See id.* at 1242. Thus, it was possible for Amex to have discovered this fraud from information in its own files. The Court of Appeals did not want to permit insurance companies who "have taken no steps to verify the identity of their applicants or medical examanees then comb their files after the incontestability period expires, looking for some basis to contend that someone other than the named insurer took part in the application or examination process." Superior Court v. Slome Capital Corp., 51 Cal. Rptr. 2d 354, 363 (1996).

The *Amex* holding added fuel to the tension between the insurance industry and the viatical settlement industry, because it in essence rewarded Mr. Morales' fraud, arguably giving other unethical viators incentive to attempt the same scheme. AIDS advocates were pleased with the verdict; the worry was that if the case had come out the other way, payouts on policies issued to those who die of AIDS would be subject to investigations, thus delaying benefits. *See* Chris DiEdoardo, *Patient Advocates Take Heart from Ruling on Life Insurance*, SAN DIEGO DAILY TRANSCRIPT, Feb. 26, 1997, at A1; *see also* Victoria Slind-Flor, *Ninth Circuit Gives Victory to Viaticals*, NAT'L L.J., Mar. 10, 1997, at A6.

Nonetheless, viators may not be able to easily duplicate Mr. Morales' fraud. As the court said, all Amex had to do to prevent this fraud was to require proof of identity. *See Amex Life Assur.*, 14 Cal. 4th at 1243. Future unethical viators will have to find impostors who match their physical descriptions closely if not identically; further, they will need to produce whatever sort of identification the insurance company requests. Thus, this type of fraud is relatively easy to curtail.

99. In *Protective Life Ins. Co. v. Sullivan*, 425 Mass. 615 (1997), Dennis Sullivan also misrepresented his HIV status on his application for life insurance from Protective Life. He authorized Protective Life to conduct medical tests, including

With few exceptions, the general rule remains that even a fraud defense is barred by the expiration of an incontestability period, seemingly giving viators incentives to attempt these kinds of frauds. However, the *Amex* and *Protective Life* decisions actually decrease the potential for such fraud by providing

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an HIV test, but Protective Life never did so, and issued the policy with a two year incontestability period, with an exception for fraud, on November 8, 1991. *See Protective Life*, 425 Mass. at 617.

Mr. Sullivan's policy stated: "[Protective Life] cannot bring any legal action to contest the validity of this policy after it has been in force two years except for failure to pay premiums unless fraud is involved." Protective Life Ins. Co. v. Sullivan, 89 F.3d 1, 2 (1996). This policy language was approved by the Massachusetts Commissioner of Insurance in 1988 as being in conformance with the applicable statute. *See id.*

In October 1993, Sullivan undertook to viaticate the policy with Dignity Partners; Dignity submitted assignment papers to Protective Life, and when Protective Life approved the assignment on December 22, 1993, Dignity paid Sullivan the proceeds from the viatical settlement. *See Protective Life,* 425 Mass. at 617. On April 15, 1994, Protective Life filed suit to rescind the policy, claiming Sullivan obtained the policy through fraudulent misrepresentations. *See id.* at 615. According to the Supreme Judicial Court of Massachusetts ("SJC"):

> It is undisputed that Sullivan knew he was HIV-positive when he applied for the life insurance policy, that he failed to disclose that he was seeing a physician for treatment of this condition despite questions calling for this information, and that Protective Life would not have issued the policy had it known of Sullivan's true medical condition.

Id. at 618.

Sullivan and Dignity Partners moved to dismiss the action as violating the Massachusetts law, in that the two year incontestability period had expired. *See Protective Life*, 89 F.3d at 3. The district court denied the motion, and after a trial, found that Massachusetts state law did not bar Protective Life's action, and thus entered a judgment for Protective Life. *See id.* Sullivan died on April 4, 1995, so the claims against him were dismissed. *See id.*

Dignity appealed to the First Circuit, which in July 1996, certified the issue to the SJC. *See id.* at 4. The SJC held that Massachusetts state law does not permit a fraud-based exception to the incontestability statute, regardless of the policy's language. *Protective Life,* 425 Mass. at 615. The court found that Sullivan's "wilful concealment of his medical condition was deplorable and deserve[d] condemnation." *Id.* at 630. However, Sullivan specifically authorized Protective Life to conduct whatever medical tests it deemed necessary, including an HIV test. *See id.* at 617. If Protective Life had not waived the tests, it would have learned about the fraud, presumably prior to issuing the policy, but certainly before the expiration of the incontestability period. The *Protective Life* court made clear that Massachusetts insurance companies have a two year finite period to investigate suspected fraud, and after such period, they are bound to pay, even if they later learn the insured lied about his or her health, and even if the policy itself contains an exception to the incontestability period for fraud. *See id.* at 632; *see also* John Ellement, *Ruling Called Win For Terminally Ill: SJC Limits Life Insurance Fraud Detection*, BOSTON GLOBE, July 30, 1997, at B2.

insurance companies with greater incentives to process their applications promptly and thoroughly.[100] The result is a risk allocation that requires insurance companies to actively follow up suspected fraud, and to engage in such prophylactic measures as requiring blood tests and demanding verifiable picture identifications from individuals who appear for medical exams. While these measures may add some marginal cost to implement in the aggregate, they will prove to be cost efficient in the long run, for the industry as a whole, if they prevent even just one *Amex* and *Protective Life* fraud from occurring.

3. *Viator Fraud on Viatical Settlement Firms*

The third scenario results in two forms of fraud, this time between viators with valid and presumably incontestable policies, and viatical settlement firms. The first form of fraud involves the viator compromising his or her health for a higher payment upon viatication; AIDS patients seeking the highest possible payment for policies, hoping to present themselves with the shortest life expectancy possible, delay starting life-prolonging therapies until they have sold their policies.[101] As a result, viators may compromise their own health, which is their personal choice. However, this behavior essentially defrauds the viatical settlement firm that purchased the policy for a price it believed reflects the viator's probable life expectancy. If the viator then begins a successful course of treatment, with the effect of increasing the viator's life expectancy, the viatical settlement firm has incorrectly priced the viatical settlement and has eroded its profit margin. If this occurs often enough, viatical settlement firms may decide not to viaticate policies, to the ultimate detriment of all potential viators.

100. The idea of fraud also arises in other areas of insurance, such as health insurance. In *Blue Cross & Blue Shield of Georgia v. Sheehan*, 215 Ga. App. 228 (1994), for example, Georgia's Court of Appeals held that an insurance company could not rescind health insurance coverage because of its failure to note a pre-existing HIV condition, but said that the insurance company could pursue a fraud action. *See Blue Cross*, 215 Ga. App. at 229-30. The insurance company had the right to demand a medical examination, but it never did so. *See id.* at 230; *see also Incontestability Clause Trumps Impostor Defense in California HIV Case*, MEALEY'S INS. L. WEEKLY, Mar. 6, 1997; Koehler, *supra* note 83, at C12.

101. *See* Vickers, *supra* note 39, § 3, at 5; *see also* Mannino, *supra* note 40, at 72.

The second form of viator fraud on viatical settlement firms centers on the viator compromising his or her ethics, not health. Viators may attempt to viaticate the same policy with different viatical settlement firms, a practice which was more possible in the infancy of this industry, when neophyte viatical settlement firms were undertaking their first viatical settlements.[102] Viators could also viaticate policies written by foreign life insurance companies subject to insurance laws that permit immediate cancellation. The viator would then sell his or her policy to the viatical settlement firm and immediately cancel the policy, leaving the viatical settlement company with no asset on which to collect. Similarly, viators could viaticate the policies and leave the country or disappear, leaving the viatical settlement firm and the investors in limbo, as life insurance companies typically will not pay out on policies in the absence of a death certificate.[103]

This form of fraud would be fairly easy to eliminate if the viatical settlement firm simply required the applicant to surrender the actual policy rather than a copy. Further, the viatical settlement firm could withhold the proceeds until it has written confirmation from the issuing insurance company that the policy is in full force and effect.

4. *Viatical Settlement Firm Fraud on Viators and on Viatical Investors*

The last scenario involves viatical settlement firms that engage in fraudulent behavior with respect to viators, who take on faith what information, if any, the viatical settlement firms provide.[104] Some firms try to avoid paying the settlement amount when due.[105] Recent regulations based on the NAIC Models

102. *See* David Sussman, *Cashing out Before the End*, MINNEAPOLIS - ST. PAUL CITY BUS., Dec. 16, 1994, at 11.

103. *See* Vickers, *supra* note 39, § 3, at 5.

104. *See* Debora Vrana, *U.S. Charges Four with Fraud in Life Insurance Investment Case*, L.A. TIMES, Apr. 22, 1997, at D1. According to the Texas Securities Commissioner, the recurring theme is that investors are told that the particular viators will die within a year or two. Because of the new treatments for AIDS, this is not always the case. Since August 1998, a North American Securities Administrators Association task force has been looking into viatical settlements. *See* Treaster, *supra* note 35, § 3, at 1.

105. Credit Life Corp, Inc., a Florida viatical settlement firm, purchased 30 policies from viators in 1990 and then failed to pay the viators for them. Florida

have lessened the potential for this kind of fraud, but only in the states where such regulations are in place.[106]

Viatical settlements have been judicially determined to fall outside the protections of the Securities Laws,[107] leaving investors to gather what information they can when deciding whether to commit funds to an investment in viatical settlements. If a viatical settlement firm represents that it is buying policies from viators, and purports to resell them to investors, the investors must take that representation on faith, without any of the protections of the Securities Act.[108]

An egregious case of fraud by a viatical settlement firm involved Personal Choice Opportunities ("PCO"), a Palm Springs, California viatical settlement company accused of selling investors interests in non-existent policies. The firm was accused of defrauding almost 1000 investors who loaned $50 million to PCO, purportedly to purchase policies from the terminally ill.[109]

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authorities closed the firm, requiring insurers to reissue the policies and return them to the viators. Two viatical companies made good on most of the polices. *See* Mannino, *supra* note 40, at 72; *see also* Lois Caliri, *Gambling on Death: Life Policies for Sale*, CENTRAL PENN BUS. J., Aug. 4, 1995, at 1; Slind-Flor, *supra* note 98, at A6; Helen Huntley, *State Moves to Close Firm*, ST. PETERSBURG TIMES, Feb. 22, 1994, at 10A.

106. *See supra* note 62.

107. *See* SEC v. Life Partners, Inc., 87 F.3d 536 (D.C. Cir. 1996).

108. A Florida viatical settlement firm called United Benefits sold approximately $4 million worth of non-existent life insurance policies to investors. The principals of the company misappropriated the investor's funds for their personal use. The firm's assets were frozen by the federal courts, and an injunction was filed against them. The SEC recently put the firm out of business. *See* Jane Bryant Quinn, *Viatical Life Insurance Deals Require Scrutiny*, BALTIMORE SUN, Oct. 23, 1995, at 13C; *see also Florida Office of the Comptroller, Viatical Settlements — Humanitarian Investments with Great Risk of Fraud*, PR NEWSWIRE, Apr. 16, 1996; Thomas W. Johnson, *Life Insurance as a Liquid Asset*, FINANCIAL PLANNING, Dec., 1996, at 102.

109. PCO did not pay out any insurance proceeds or interest on the loaned money. Instead, the company used new investors' money to pay old investors, and ultimately to pay themselves. The owner of PCO, along with the owner of Escrow Plus, Inc., the firm that claimed to administer the viatical program for PCO, and two viatical settlement brokers who marketed the non-existent policies, were charged with conspiracy to commit securities mail and wire fraud. *See Viatical Settlement Investors Charge Fraud After Sting Operation*, MEALEY'S LITIG. REP.: INS. FRAUD, May 22, 1997; *see also* Vrana, *supra* note 104, at D1.

A doctor involved in the scheme was also indicted and ultimately plead guilty to conspiracy to commit securities, mail and wire fraud. The doctor admitted that he lied to investors, telling them that he had reviewed the medical histories of hundreds of terminally ill people who had sold their life insurance policies to PCO.

A large-scale fraud like PCO, with the attendant publicity, has

These lies, in the form of oral and written medical opinions, arguably lent credibility to the scam. *See* David M. Halbfinger, *Man Who Promised Profits Pleads Guilty in $95 Million Fraud*, N.Y. TIMES, Nov. 14, 1997, at B3; *see also Over Half of $95 Million Invested in Scam Found*, BUFFALO NEWS, Oct. 5, 1997, at 15A.

The scam ran from June 1996 until March 1997. Investors were induced to "lend" funds to PCO to finance the purchase of life insurance policies from terminally-ill policyholders, with a promise of a 25% annual return. Investors advanced a minimum of $25,000 each, with some investors advancing as much as $300,000. Investors were told that their funds would be held by Escrow Plus, Inc. until PCO turned over the policies that collateralized the loans. Insurance benefits paid on the policies upon the insureds' death were to be paid to Escrow Plus, to be disbursed to the investors. This was apparently such a believable deal that some viatical brokers invested their own money in PCO. The inclusion of an escrow fund with a respected track record led some investors to believe the investment was legitimate. Instead of buying policies, Escrow Plus disbursed most of the investor funds to the president of PCO, David Laing. *See* John Rebchook, *Pitchman Arrested in Insurance Scheme Investors Defrauded in Plan to Buy Policies from Terminally Ill*, DENVER ROCKY MOUNTAIN NEWS, Apr. 15, 1997, at 1B; *see also* Gail Dianne Cox, *Growth Market in Death Futures Spawn Suits*, NAT'L L.J., May 26, 1997, at A9; David McNary, *Ponzi Scheme Exposed: Canoga Park Man Victimized by Fraud*, DAILY NEWS OF L.A., Apr. 24, 1997, at B1.

Once the California Department of Corporations discovered in February 1997 that PCO was operating without a license, it subpoenaed the company's records. PCO refused to comply with the subpoena, claiming confidentiality. This response triggered action by the Federal Bureau of Investigation, and the California Bureau of Investigation. *See Viatical Settlement Investors Charge Fraud After Sting Operation*, *supra* note 109; *see also* Halbfinger, *supra*, at B3. Ultimately, a receiver for PCO's assets was appointed. State officials in Idaho, South Dakota, California, Washington, Colorado, Montana, and New Mexico, and Wisconsin began investigating PCO. *See Four Charged in Insurance Scam*, ST. LOUIS DISPATCH, Apr. 8, 1997 at 1A; *see also* Joe Kolman, *Montana Investors Lose Money in $95 Million Viatical Scam*, BILLINGS GAZETTE, May 20, 1998.

Colorado Securities Commissioner Philip Feigin began conducting an investigation of PCO. *See* Bill Morlin, *Charges Dropped in Insurance Scam; State or Civil Action Still Possible*, SPOKESMAN-REV., July 10, 1997, at A1; *see also* Rebchook, *supra* at 7B.

The Idaho Department of Finance filed suit against PCO for alleged investment fraud and violation of the state securities act. The department sought to have the defendants enjoined from future violations, and sought restitution for all of the approximately 40 Idaho investors, along with civil penalties. *See* STATE OF IDAHO, DEPARTMENT OF FINANCE, NEWS RELEASE, STATE SUES SEVEN DEFENDANTS FOR INVESTMENT FRAUD: OVER 57 MILLION ALLEGEDLY INVESTED IN VIATICAL SETTLEMENT SCHEME (1997); *see also Backers of Viatical Scam Busted in Idaho*, SPOKESMAN-REV., June 14, 1997, at A13; Ron Lent, *Federal Authorities Broaden Case Involving Alleged Viatical Scam*, J. OF COM., Apr. 28, 1997, at 8A.

Michael Vargon, deputy director of the New Mexico Securities Division, reports that at least five New Mexicans lost money in the PCO scam. His department also began an investigation of PCO. *See* Macario Juarez, Jr., *New Mexicans Among Group Bilked in Insurance Scam*, ALBUQUERQUE TRIB., Dec. 11, 1997, at C4.

the potential to taint the entire viatical settlement industry, and provides the SEC with additional incentive to regulate this industry.[110] The specter of this kind of fraud presents serious risks for investors in viatical settlements, who, under current law, are denied the disclosure and antifraud protection of the Securities Laws.

Steps have been taken to combat fraud on viators. Viatical trade organizations have adopted codes of conduct,[111] the NAIC has adopted its Model Act and Regulations,[112] and 25 states have enacted regulations based, at least in part, on the NAIC Models.[113] The state regulations decrease the potential for fraud on viators by mandating disclosures by viatical settlement firms, setting up advertising standards and requiring viatical settlement firms to escrow funds to be paid to viators.[114] The state statutes are an appropriate response to a humanitarian desire to protect a vulnerable population, but regulation at the state level of the purchase side of viatical settlements is insufficient. State insurance regulations cannot be expected to provide the comprehensive protections contained in the Securities Laws.

The existing regulation of viatical settlements fails to protect investors by alleviating the fraud in the sale side of the industry. Investor protection is essential, simply to insure their

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The Wisconsin Securities Commission petitioned for an order of suspension of agent license and of prohibition for a salesperson who sold PCO interests, which it considers to be securities. *See* In the Matter of Daniel Lawrence Kouba, CRD No. 1254972, Respondent, File Number S-97079, Wisconsin Securities Commission, 1998 Wisc. Sec. 1998 WL 155402 (Mar. 16, 1998).

110. "What's so sad about this case is that it will affect my member companies — legitimate, licensed firms trying to comply with the law," said William E. Kelley, executive director of VAA. *See* Vrana, *supra* note 104, at D1.

111. *See* Gene Meyer, *Mixing Death and Profit: Viatical Contracts Bring Cash to the Terminally Ill, Profit to Investors*, KANSAS CITY STAR, May 10, 1998, at F1; *see also supra* note 59, at 15-16.

112. *See supra* note 62, at 362.

113. *See supra* note 13.

114. *See* Crites-Leoni & Chen, *supra* note 9, at 83. However, the viatical settlement industry has a huge financial investment in leaving the industry unregulated. The industry successfully watered-down a 1993 Texas bill to ensure that state insurance regulators were unable to look at a viatical settlement company's records. The proposed language was so vague as to be unenforceable. A subsequent bill eliminated this vagueness, but the two year delay in getting appropriate statutory language gave unscrupulous viatical settlement firms a nice window of opportunity in which to operate. *See NAIC Mulls Option*, *supra* note 63, at 1.

continued presence in this market.[115] Without investors, the viatical settlement industry could trickle down to the purchase of policies by only those truly altruistic persons or firms, leaving many viators with no access to death benefits with which to pay for life-prolonging medical treatments.

The better approach is to protect investors, and by extension, viators, by bringing viatical settlements within the scope of the Securities Laws. This would provide investors with disclosure and remedies, and provide viators with a broader range of potential investors. If viatical settlement investors were granted the protections of the Securities Laws, viatical settlement firms would have an affirmative obligation to disclose as risk factors the possibilities of conflicts of interest, confidentiality concerns, and the various forms of fraud present in the viatical settlement industry, enabling investors to make informed decisions about whether to invest in viatical settlements. Furthermore, defrauded investors would have the full arsenal of Securities Laws remedies, beyond a simple common law fraud action. These protections, while admittedly somewhat costly to the viatical settlement firms, may ultimately prevent investors from moving their funds to ventures that disclose material information.

III: Classifying Viatical Settlements as Securities: Decreasing the Potential for Fraud on Investors

A comprehensive way to increase investor protection and curtail fraud in the resale side of the viatical settlement industry would be to classify fractional interests in viatical settlements as securities for purposes of the Securities Laws; their sales would thereby fall under the protection of the Securities

115. "The need to protect investors is acknowledged by nearly all responsible participants in the viatical settlement industry." *See* Brief for the SEC, Appellee at 8, SEC v. Life Partners, Inc., 898 F. Supp. 14 (D.D.C. 1995) (Nos. 95-5364 & 96-5018).

Laws, complete with antifraud and disclosure obligations,[116] and civil remedies.[117]

Fractional interests in viatical settlements clearly fall within the letter of the Securities Laws. These laws were enacted with the overall goal of investor protection, through mandatory disclosure of information.[118] The status of viatical settlements under the Securities Laws has been the subject of much debate, both within the viatical settlement industry and in the courts. The only court to rule directly on this issue was the D.C. Circuit Court of Appeals that heard and incorrectly decided the *Life Partners* case.[119] The D.C. Circuit had an opportunity to advance the goals of the Securities Laws, while adhering to sound precedent. Instead, the court chose to create a new bright-line test, with no explicit precedential support, at the cost of ignoring over fifty years of thoughtful case law.[120]

The SEC, worried about the adequacy of disclosure to investors in viatical settlements,[121] had been monitoring the viatical settlement industry, and in particular, a large viatical settlement firm in Waco, Texas called Life Partners, Inc. and its

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116. One effect of requiring sellers of fractional interests in viatical settlements to register such offerings would be increased costs, such as the costs of preparing a registration statement, in the absence of an available exemption from registration, and the cost of compliance thereafter with the continuing disclosure requirements of the Exchange Act. The cost of compliance is more than simply money; the process, initially and on an on-going basis, is time consuming, and exposes the issuer and various of its related persons to potential liability. *See generally* Escott v. BarChrist Construction Corp., 283 F. Supp. 643 (S.D.N.Y. 1968).

The financial costs would fall, at least initially, on the viatical settlement firm, as issuer of the securities, and could be passed on to, or shared with the investors. Life Partners argued that passing these costs on to investors would cause a corresponding decrease in the amount paid to viators. *See* SEC v. Life Partners, Inc., 87 F.3d 536, 539 (D.C. Cir. 1996). If this proved true, the cost might be well worth the benefit of keeping investors in the industry.

117. The Securities Laws "provide civil remedies for fraud which are more protective of victims than is common law fraud. . . .in general the securities laws lower the requirements of recovery." James D. Gordon III, *Common Enterprise and Multiple Investors: A Contractual Theory For Defining Investment Contracts and Notes*, 1998 COLUM. BUS. L. REV. 635, 637 (1998).

118. *See infra* notes 136-43 and accompanying text for a discussion of the goals of the Securities Laws.

119. *See* SEC v. Life Partners, Inc., 87 F.3d 536 (D.C. Cir. 1996), *reh'g denied*, 102 F.3d 587 (D.C. Cir. 1996).

120. *See Life Partners*, 87 F.3d at 551 (Wald, J., dissenting).

121. *See* Deeley, *supra* note 12, at 383.

president, Brian Pardo.[122] The SEC began a lengthy and ultimately unsuccessful battle to classify fractional interests in viatical settlements sold by Life Partners as securities, subject to the registration requirements of the Securities Act. The SEC brought suit against Life Partners, alleging, among other things, the sale of unregistered securities.[123] Life Partners disputed that the fractional interests in the viatical settlements it marketed were subject to the Securities Laws.[124] The SEC was

122. Mr. Pardo was a major part of this litigation. He had difficulties with various federal regulators prior to the Life Partners litigation. In 1989, the SEC alleged that Mr. Pardo engaged in securities fraud in his capacity as chairman and CEO of another company, ASK Corporation. *See* Plaintiff SEC's Brief in Support of Motion for Preliminary Injunction and Other Provisional Relief at 13, SEC v. Life Partners, Inc., 898 F. Supp. 14 (D.D.C. 1995) (No. 1:94CV01861). Specifically, the SEC alleged that Mr. Pardo falsified financial reports to ASK shareholders. *See* Sougata Mukherjee, *Insurance Policies for the Terminally Ill Come Under Fire from Federal Agencies*, Bus. J. San Jose, May 12, 1997; *see also* Caliri, *supra* note 105, at 1. In 1991, Pardo was enjoined from violating the antifraud and books and records provisions of the Exchange Act as a consequence of his association with ASK Corporation, which was forced into bankruptcy while under his control. *See* Plaintiff SEC's Brief in Support of Motion for Preliminary Injunction and Other Provisional Relief at 1, SEC v. Life Partners, Inc., 898 F. Supp. 14 (D.D.C. 1995) (No. 1:94CV01861).

Also in 1991, Pardo was sued by the Federal Deposit Insurance Corporation for having defaulted on a loan from a failed savings and loan, and thereafter became subject to an unsatisfied judgment that, with interest, exceeded $3 million. *See* Brief of the SEC, Appellee at 17, SEC v. Life Partners, Inc., 898 F. Supp. 14 (D.D.C. 1995) (Nos. 95-5364 & 96-5018).

In yet another action, this time with the Resolution Trust Corporation, Pardo was found liable and was ultimately the subject of a sizable judgment in connection with a $1.78 million loan, plus interest and legal fees, made to Pardo and ASK, from a now-defunct federally-insured savings and loan association. *See* Brief of the SEC, Appellee at 17, SEC v. Life Partners, Inc., 898 F. Supp. 14 (D.D.C. 1995) (Nos. 95-5364 & 96-5018); *see also* Rob Wells, *House Candidate Pardo Topic of Federal S&L Fraud Inquiry*, Austin American-Statesman, Feb. 16, 1996, at D2.

Apparently, Mr. Pardo, who ran an unsuccessful campaign for Congress in 1996, was upset with the SEC's comments about him to the press, and filed a Hatch Act complaint and a libel suit against the SEC. *See Brady, Babin Snare GOP Runoffs for House Seats*, Hous. Chron., Apr. 10, 1996, at 15; *see also* Defendants' Opposition to the SEC's Motion for Supplemental Provisional Relief at 11-13, SEC v. Life Partners, Inc., 898 F. Supp. 14 (D.D.C. 1995).

123. SEC v. Life Partners, Inc., 898 F. Supp. 14, 18 (D.D.C. 1995).

124. Life Partners argued that fractional interests in viatical settlements do not constitute securities for purposes of the Securities Laws. Life Partners also raised a number of other arguments in court and in the press to support its position, including a lack of investor losses, an appeal to public sympathy and a request to create a public interest exemption to the Securities Laws.

First, Life Partners claimed the suit was without merit, because no Life Partners investors suffered losses, and further, there was no evidence that Life Partners misappropriated funds. According to Life Partners' counsel: "[the SEC doesn't] make a single allegation in this complaint that there's been any loss to any investor. . .they are essentially bringing a lawsuit without any precipitating event. You have to ask, 'who are they trying to protect?'" Tony Munroe, *SEC Sues Dealer in Death Futures*, WASH. TIMES, Aug. 27, 1994, at D5 (quoting Ida Draim, counsel for Life Partners).

The SEC did not allege investor losses, or misappropriation of funds by Life Partners, but neither point was required to prove the allegations actually made by the SEC. In fact, because the Securities Laws are intended to *prevent* abuse, the fact that no investor has lost any funds yet makes this situation ripe for preventative intervention. According to the SEC, "the securities laws, and in particular the disclosure requirements of the 1933 and 1934 Acts, are intended to prevent abuses before they arise." SEC v. Life Partners, Inc., 87 F.3d 536, 539 (D.C. Cir. 1996). *See LPI Characterizes Lawsuit as Groundless*, BUS. WIRE, Aug. 31, 1994; *see also Life Partners*, 87 F.3d at 556 (Wald, J., dissenting).

Second, Life Partners played the sympathy card, arguing that the lawsuit would harm the AIDS community by affecting the viatical settlement market, in which Life Partners was a major participant. However, Life Partners was not the only available viatical settlement firm. The SEC correctly countered that impact on the viatical settlement market should not be dispositive, and the district court agreed. *See* SEC v. Life Partners, Inc., 898 F. Supp. 14, 23 (D.D.C. 1995); *AIDS Insurance Benefits Trader Sued*, DES MOINES REG., Aug. 26, 1994, at 8; *see also Judge Backs SEC in Viaticals Case*, THE INSURANCE ACCT., Sept. 11, 1995, at 1.

NAPWA intervened in the litigation, and at a hearing argued that finding viatical settlements constituted securities "is essentially going to end this industry as we know it." Plaintiff SEC's Post-Hearing Brief in Support of Motion for Preliminary Injunction and Other Provisional Relief and in Opposition to Defendants' Motion to Dismiss at 10, SEC v. Life Partners, Inc., 898 F. Supp. 14 (D.D.C. 1995) (No. 1:94CV01861). This is a dramatic overstatement, but in the absence of appropriate protections for investors in viatical settlements, perhaps not such a bad result. Hopefully, a reconstituted viatical settlement industry, selling securities in compliance with the Securities Laws, would protect investors by providing them with the material information they need to make a sound investment decision.

The district court considered the "apparent lack of injury in fashioning an equitable remedy," and "the effects of the Commission's request for relief on a business that helps so many terminally ill patients." *Life Partners*, 898 F. Supp. at 23. Accordingly, the court concluded that the SEC was entitled to more limited preliminary relief than it was seeking, and declined to enjoin Life Partners from selling fractional interests in viatical settlements pending completion of its efforts to comply with the Securities Laws. *See* SEC v. Life Partners, Inc., 912 F. Supp. 4, 6 (D.D.C. 1996).

Finally, Life Partners claimed that the SEC was seeking the "draconian result" of "put[ting] an end to a business that provides over forty million dollars a year to persons dying of AIDS," and so they argued that, even if the court finds they are selling non-exempt and unregistered securities, it should decline to issue an injunction because to do so would be contrary to "the public interest," essentially seeking a judicially-created "public interest" exemption from the Securities Laws. Plaintiff SEC's Reply Brief in Support of Motion for Preliminary Injunction successful at trial,[125] but the D.C. Court of Appeals reversed the trial court decision.[126] After the SEC unsuccessfully sought a rehearing on the issue,[127] the agency filed an unsuccessful Motion Seeking Leave to Amend Complaint.[128] Although the SEC ultimately declined to appeal the decision to the United States Supreme Court, the agency has continued to pursue, through other avenues, the legally sound classification of fractional interests in viatical settlements as securities.[129]

An analysis of *Life Partners* will illustrate those issues that arise in connection with regulating sales of fractional interests

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and Other Provisional Relief and in Opposition to Defendants' Motion to Dismiss at 18, SEC v. Life Partners, Inc., 898 F. Supp. 14 (D.D.C. 1995) (No. 1:94CV01861).

No such "public interest" exemption from the registration requirements of the Securities Laws exists. According to the SEC, "the defendants' view of where the public interest lies cannot take precedence over that of Congress. Many companies engage in socially useful activities, but are nevertheless required to comply with the federal securities laws. Congress enacted the securities laws to protect investors. It did not exempt from their application enterprises that claim to advance the public weal." Brief of the Securities and Exchange Commission, Appellee at 3-4, SEC v. Life Partners, Inc., 898 F. Supp. 14 (D.D.C. 1995) (Nos. 95-5364 & 96-5018). If Life Partners intended to conduct a humanitarian, non-profit enterprise operating in the public interest, it could avail itself of the existing exemption from registration under § 3(a)(4) of the Securities Act, which exempts:

> [a]ny security issued by a person organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes and not for pecuniary profit, and no part of the net earnings of which inures to the benefit of any person, private stockholder or individual.

15 U.S.C.A. § 77c(a)(4) (1998). Life Partner's argument assumes that the SEC is seeking to put it out of business, and that Life Partners would somehow be unable to stay in business if it elected to comply with the Securities Laws. Although Dignity Partners has left the viatical settlement industry, there is no evidence to indicate that the Securities Act compliance was even a factor. *See supra* note 32.

Life Partners made two other arguments to support its claims that fractional interests in viatical settlements were not securities. First, it claimed that viatical settlements were simply insurance agreements and therefore exempt from the registration requirements of § 5 through § 3(a)(8). *See infra* note 163 for discussion of the insurance issue. Life Partners claimed in the alternative that if their viatical settlements were found to be investment contracts, it would be nonetheless exempt from the registration requirements of § 5 of the Securities Act under the § 4(2) private offering exemption. The court was unpersuaded. *See Life Partners*, 912 F. Supp. at 9-11.

125. *See* SEC v. Life Partners, Inc., 898 F. Supp. 14, 14 (D.D.C. 1995).

126. *See* SEC v. Life Partners, Inc., 87 F.3d 536, 536 (D.C. Cir. 1996).

127. *See* SEC v. Life Partners, Inc., 102 F.3d 587, 588 (D.C. Cir. 1996).

128. *See* SEC v. Life Partners, Inc., 986 F. Supp. 644, 645 (D.C. Cir. 1997).

129. *See infra* Part IV for a discussion of the *Mutual Benefits* case and states' efforts to regulate fractional interests in viatical settlements.

in viatical settlements, and will demonstrate the error in the D.C. Circuit's reasoning, and the resulting missed opportunity to increase investor protection, fulfilling the spirit and the letter of the Securities Laws.

A. *Factual Context of the* Life Partners *Litigation*

In August 1994, the SEC filed a complaint against Life Partners, alleging that the fractional interests in viatical settlements it marketed constituted securities for purposes of the Securities Act.[130] The SEC further alleged that Life Partners violated the registration and antifraud provisions of the Securities Laws by selling these interests.[131] The district court agreed and issued four separate orders over a six month period, ultimately enjoining Life Partners from selling fractional interests in viatical settlements, pending appeal.[132]

130. The SEC was careful to say that it was not characterizing all viatical settlements as securities, *per se*. Rather, its focus was on the structure of the sales: specifically, Life Partners' practice of grouping policies and selling them to investors. *See Life Partners*, 898 F. Supp. at 18-19. ("The Commission readily agrees that a straight viatical settlement is not a security. It is the methods employed by defendants which are challenged.") As the SEC said, the "central question in this case is whether such investments — as packaged, offered, sold, and administered by the defendants — constitute securities. The case does not raise the question whether a so-called viatical settlement itself constitutes a security, nor does the SEC take the position that such a transaction does constitute a security." *See* Plaintiff SEC's Post-Hearing Brief in Support of Motion for Preliminary Injunction and Other Provisional Relief and in Opposition to Defendants' Motion to Dismiss at 10, SEC v. Life Partners, Inc., 898 F. Supp. 14 (D.D.C. 1995) (No. 1:94CV01861) (emphasis omitted).

131. *See* SEC v. Life Partners, Inc., 898 F. Supp. 14, 18 (D.D.C. 1995).

132. *See* SEC v. Life Partners, Inc., No. 94-1861, 1996 U.S. Dist. LEXIS 3451, at *3 (D.D.C. Mar. 19, 1996). Life Partners operated a number of programs involving the sale of life insurance policies purchased from terminally-ill policyholders, several of which were problematic for the SEC. *See Life Partners*, 898 F. Supp. at 18. The SEC was not concerned with companies that purchase policies for their own account or that act as brokers. *See supra* note 12. However, because Life Partners actually assumes ownership of the policies and then sells fractional interests in the policies, the transactions are thereby brought within the Securities Laws. *See* Munroe, *supra* note 124, at D5.

Life Partners offered viatical settlements to individuals who invested as little as $650 and purchased as little as three percent of a policy. *See* SEC v. Life Partners, Inc., 87 F.3d 536, 539 (D.C. Cir. 1996). Life Partners also offered viatical settlements to Individual Retirement Accounts ("IRAs"). *See id.* A detailed discussion of the program by which investors could participate in viatical settlements through their IRAs is beyond the scope of this Article. In short, the Internal Revenue Code prohibits funds from an IRA to be used to purchase life insurance policies. *See* I.R.C. § 408(a)(3) (1994). Life Partners attempted to circumvent this prohibition by structuring the purchase of policies through a separate trust, with Life Partners as trustee. *See Life Partners*, 87 F.3d at 539. The investors instructed the IRA to lend money to the trust and to take back a non-recourse note. *See id.* The trust used the loan proceeds to purchase an interest in a life insurance policy, with the death benefits of that life insurance policy collateralizing the loan. *See id.* When the insured died and the benefits were paid, the proceeds were paid against the note held by the IRA. *See id.*

Both Life Partners' individual investor and IRA programs went through three incarnations during the course of the litigation. *See id.* Common to all three incarnations were the pre-purchase efforts undertaken by Life Partners, including locating potential viators, evaluating the policyholder's medical condition, reviewing the terms of the policy, negotiating the purchase price, and preparing and executing certain legal documents. *See Life Partners*, 87 F.3d at 539-40. The differences between the three incarnations centered on the ever-decreasing amount of post-purchase efforts provided by Life Partners, which, Life Partners contended, settled the question of whether the fractional interests in viatical settlements were securities. *See id.* at 538. Sterling Trust Company, an independent escrow agent, acted as agent for Life Partners and actually performed most of the post-purchase activities/administrative functions on its behalf. *See id.* at 540.

In the first incarnation, called "Version I" by the court, either Life Partners or Mr. Pardo was listed as the policy owner, even after the investors had purchased their interests. *See id.* at 545. Thus, the investors had contractual rights only against Life Partners, and not against the issuing insurance company. *See id.* Life Partners claimed that the investors were the legal policy owners, but, as some sort of accommodation to the insurance companies, Pardo or Life Partners remained the record owners. *See Life Partners*, 87 F.3d at 538. According to Life Partners, this was not evidence of any continuing entrepreneurial role for Life Partners. *See id.* at 539. In Version I, Life Partners offered some post-purchase administrative services, including monitoring the insured's medical condition, insuring that the premiums were paid so that the underlying policy did not lapse, converting group policies into individual policies, and creating a secondary market in viatical settlements by arranging the resale of investors' interests when requested and feasible. *See id.*

On August 30, 1995, United States District Court for the District of Columbia held that Life Partners had violated the Securities Laws by selling unregistered securities. *See* SEC v. Life Partners, Inc., 898 F. Supp. 14, 24 (D.D.C. 1995). The court ordered Life Partners to bring its operations into compliance with the Securities Laws "forthwith" but did not issue an injunction prohibiting Life Partners from selling viatical settlements. *See id.*

On September 29, 1995, the district court denied Life Partners' motion for modification and a partial stay of the August 30th order, and directed Life Partners to file a progress report within twenty days, detailing Life Partners' efforts to comply with the Securities Laws. *See* SEC v. Life Partners, Inc., 912 F. Supp. 4, 7 (D.D.C. 1996). Life Partners attempted to comply with the September 29th order by reducing the amount of post-purchase efforts that it undertook. *See id.* Life Partners' view, later validated by the Court of Appeals, was that this approach would keep the sale of fractional interests from falling within the statutory definition of a "security." *See id.*

On January 22, 1996, however, the district court amended its August 30th order and held that the steps that Life Partners had taken were insufficient. *See*

Life Partners appealed the trial court decision to the United States District Court for the District of Columbia. On July 5, 1996, that court, reviewing the issues *de novo*,[133] reversed the district court 2-1, holding, among other things,[134]

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id. at 12. This time, the court enjoined Life Partners from offering or selling unregistered fractional interests in viatical settlements. *See id.* On February 23, 1996, Life Partners filed an affidavit, asserting its had complied with the January 22nd order and, accordingly, stating that it planned to resume sales of fractional interests in viatical settlements. *See* SEC v. Life Partners, Inc., No. 94-1861, 1996 U.S. Dist. LEXIS 3451, at *1 (D.D.C. March 19, 1996). The affidavit made clear that Life Partners interpreted the January 22nd order to mean that if it discontinued all of its post-purchase efforts, it could resume sales without running afoul of the Securities Laws. *See id.*

Between the district court's August 1995 and January 1996 orders, Life Partners, in an effort to satisfy the court, implemented what the court called "Version II." *See* SEC v. Life Partners, Inc., 87 F.3d 536, 539-40 (D.C. Cir. 1996). Version II corrected the obvious problems with Version I. *See id.* Now the investors were listed as the policy owners, and were in privity with the insurance companies. *See id.* Additionally, under Version II, both the invested funds and the death benefits, when paid, were disbursed through Sterling Trust, the independent escrow agent, and no longer through Life Partners. *See id.* Life Partners disclosed to its potential investors that Mr. Pardo was the 95% beneficial owner of Life Partners, and that he had unrelated disputes with certain federal regulatory agencies. *See id.* Finally, Life Partners specifically disclosed that investors were not obligated to retain Sterling Trust for the post-purchase efforts. *See Life Partners*, 87 F.3d at 539-40. Life Partners claimed that it furnished investors with all the information necessary for them to handle these responsibilities on their own. *See id.*

Because the district court was still not satisfied, Life Partners crafted Version III. *See id.* Mr. Pardo resigned as president of Life Partners, and was replaced by the former president of Sterling Trust, the purportedly "independent" escrow agent. *See id.* at 540. Most importantly, Life Partners disclosed that it would no longer provide post-purchase services at an investor's request, either on its own or through a designated provider such as Sterling Trust. *See id.*

The SEC was not persuaded that these changes were significant. According to the SEC, "such a cosmetic change does not transform the character of the transaction, does not diminish the investors' passivity and reliance on others to bring this investment to fruition, and thus does not take the defendants' business outside of the scope of the securities laws." Emergency Motion of Plaintiff SEC for Supplemental Provisional Relief, at 1-2, SEC v. Life Partners, Inc., 898 F. Supp. 14 (D.D.C. 1995) (No. 94-1861) (emphasis omitted).

On March 19, 1996, the district court granted the SEC's Emergency Motion for Supplemental Provisional Relief. *See* SEC v. Life Partners, Inc., No. 94-1861,1996 U.S. Dist. LEXIS 3451, at *3 (D.D.C. March 19, 1996). The court concluded that the changes made by Life Partners were merely technical in nature, as Life Partners had "done little to alter the substance of services provided to investors," and preliminarily enjoined Life Partners from selling the fractional interests, pending appeal. *See id.*

133. *See* SEC v. Life Partners, Inc., 87 F.3d 536, 541 (D.C. Cir. 1996).

134. In addition to holding that interests in viatical settlements are not securities, the D.C. Circuit ruled that viatical settlements were not exempt under

that the fractional interests in viatical settlements sold by Life Partners were not securities within the meaning of the Securities Act, and remanded the matter, with instructions to vacate the injunctions.[135]

B. *Case Law Context of the* Life Partners *Litigation*

In order to accurately evaluate the D.C. Circuit's decision, the *Life Partners* litigation must be viewed in light of its case law and statutory context, as well as its factual and procedural context. This evaluation of necessity must begin with an examination of the purposes and history of the Securities Laws, and an examination of the relevant case law interpreting those Laws.

1. *Background of the Securities Laws*[136]

After the stock market collapse in 1929, the federal government was eager to restore investor confidence.[137] Promptly after his inauguration, President Roosevelt began to push for securities reform, based on the idea that disclosing adequate information to investors would lessen or eliminate the specter of fraud.[138] According to the President, the Securities Act "adds to the ancient rule of *caveat emptor*, the further doctrine 'let the

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§ 3(a)(8) of the Securities Act as insurance contracts. For a discussion of this issue, *see infra* note 163 and accompanying text. The court further held that the notes collateralized by viatical settlements and sold to IRAs, like the viatical settlements underlying them, were not "securities." *See infra* note 164.

135. In December 1996, the D.C. Circuit denied the SEC's petition for a rehearing. *See* SEC v. Life Partners, Inc., 102 F.3d 587, 588 (D.C. Cir. 1996). The SEC then filed an unsuccessful Motion Seeking Leave to Amend Complaint. SEC v. Life Partners, Inc., 986 F. Supp. 644, 645 (D.D.C. 1997).

136. For a detailed discussion of the circumstances and considerations surrounding the enactment of the Securities Act, *see generally* James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO WASH. L. REV. 29 (1959).

137. The Securities Laws were enacted "to restore the confidence of the prospective investor in his ability to select sound securities." *See* S. REP. NO. 73-47, 1, at 6-7 (1933); *see also* H.R. REP. NO. 73-85, at 1-2 (1933).

138. The idea was not to have the federal government sign off on the soundness of any particular investment, but rather to require issuers to provide investors with necessary and material information upon which to make investment decisions. In his message to Congress on March 29, 1933, President Roosevelt said:

> Of course, the Federal Government cannot and should not take any action which might be construed as approving or guaranteeing that newly issued

seller also beware.' It puts the burden of telling the whole truth on the seller."[139]

The Securities Laws reflect the idea that information is the most important element of investor protection.[140] The Securities Act, also known as the "truth in securities" law, has two basic objectives: to insure that investors are provided with material information about securities offered for public sale, and to prevent fraud in the sale of securities.[141] To insure that issuers provide potential investors with the appropriate information, the Securities Act mandates registration of all non-exempt securities prior to their offer and sale.[142]

The provisions of the Securities Laws apply only to those investments that fall within the statutory definition of "security." Therefore, the regulation of any investment, including fractional interests in viatical settlements, depends on the threshold question of whether such an investment falls within this statutory definition.[143]

> securities are sound in the sense that their value will be maintained or that the properties which they represent will earn profit.
>
> There is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public.

H.R. REP. NO. 73-85, at 2 (1933).

139. *Id.*

140. According to the Supreme Court, the design of the statute was to "protect investors by promoting full disclosure of information thought necessary to informed investment decisions." SEC v. Ralston Purina Co., 346 U.S. 119, 124 (1953) (citing A.C. Frost & Co. v. Coeur D'Alene Mines Corp., 312 U.S. 38, 40 (1941). *See* LARRY D. SODERQUIST, SECURITIES REGULATION, 179-80 (3d ed. 1994)).

141. *See* 346 U.S. at 124 n.10.

142. The Exchange Act extends the investor protection purpose of the Securities Act to securities listed on national securities exchanges and, through the Securities Act Amendments of 1964, to securities in the over-the-counter markets. *See* 15 U.S.C. § 78a – 78mm (1994); *see also supra* SODERQUIST, note 140, at 4-8.

143. The answer to this question has regulatory and compliance implications for the seller of the instrument. In addition, the answer will determine the availability of certain remedies to purchasers of the instruments. *See* JAMES D. COX, et al., SECURITIES REGULATIONS: CASES AND MATERIALS (1991).

A necessary follow-up question is whether such a security is statutorily exempted from the registration requirements pursuant to § 3 of the Securities Act. Of course, such exempted securities are nonetheless sucbject to the anti-fraud provisions of the Securities Laws. This Part of the Article centers on the threshold definitional question, which is answered herein in the affirmative. An examination of § 3 of the Securities Act, which lists exempt securities, indicates that frac-

2. *Definition of "Security"*[144]

The Securities Act was not intended to provide a broad federal remedy for all fraud,[145] but rather a mechanism to provide investors with necessary information.[146] Courts often talk about the need for flexibility in applying this definition.[147] Cognizant of the remedial goals of the Securities Act,[148] Congress tried to craft a broad definition that would "meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."[149] Thus Congress included in the definition the catch-all phrase "investment con-

tional interests in viatical settlements are not exempt from the registration requirements of the Securities Act. *See* 15 U.S.C. § 77c(a) (1994).

One commentator argues that viatical settlements should be exempted from the Securities Act through the SEC's new administrative powers under § 28 of the Securities Act. *See* Deeley, *supra* note 12, at 410-12.

144. Unless the context otherwise requires -

> (1) The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group of index securities (including any interest therein or based on value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

15 U.S.C. § 77b(a)(1) (1994). The Exchange Act definition of "security" is substantially similar to the Securities Act definition, and, according to the Supreme Court, are to be treated as "virtually identical." Tcherepnin v. Knight, 389 U.S. 332, 335-36 (1967); *see also* 15 U.S.C. § 78c(a)(10) (1994); DePeri, *supra* note 4, at 860-61.

145. *See* Marine Bank v. Weaver, 455 U.S. 551, 556 (1982); *see also* Northland Capital Corp. v. Silver, 735 F.2d 1421, 1431 (D.C. Cir. 1984); Baurer v. Planning Group, Inc., 669 F.2d 770, 774 (D.C. Cir. 1981).

146. *See* SEC v. Ralston Purina Co., 346 U.S. 119, 124 (1953). Additionally, the Securities Laws provide civil remedies that offer more protection than a common law fraud action. *See* Gordon *supra*, note 117, at 637.

147. *See* Pinter v. Dahl, 486 U.S. 622, 653 (1988).

148. *See* Landis, *supra* note 136, at 30; *see also* SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 479 (5th Cir. 1974); William L. Doerler, *SEC v. Life Partners, Inc.: An Extended Interpretation of the Howey Test Finds That Viatical Settlements Are Investment Contracts*, 22 DEL. J. CORP. L. 253, 255-56 (1997).

149. SEC v. W.J. Howey, 328 U.S. 293, 299 (1945).

tract" to give the courts flexibility in interpreting this important and far-reaching definition.[150]

Numerous commentators and judges have analyzed the case law modifications to the definition of security in general, and investment contract in particular.[151] Thus, only a brief overview is necessary here for later application to investments in fractional interests in viatical settlements.[152]

3. *Development of Law on Investment Contracts*

The first United States Supreme Court case to interpret the definition of "investment contract" in the Securities Act was *SEC v. C.M. Joiner Leasing Corp.*[153] *Joiner* involved the offer and sale of assignments in oil leases, coupled with the promoter's promise to drill test wells.[154] The Court, in finding such offers to constitute investment contracts, adopted a broad reading of the term.[155]

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150. "Throughout the history of struggling for an appropriate definition, courts have been mindful of the fact that the bottom-line question is whether the particular investment or instrument involved is one that needs or demands the investor protection of the federal (or state) securities laws." THOMAS LEE HAZAN, THE LAW OF SECURITIES REGULATION, 30-31 (3d ed. 1996).

151. *See* Stephanie Ann Miranda, *Can Pre-Purchase Entrepreneurial Efforts Satisfy the Fourth Prong of the Howey Test?: A Critique of SEC v. Life Partners, Inc.*, 38 SANTA CLARA L. REV. 269, 279-82 (1997) for a detailed discussion of the foundation of investment contract analysis.

Judge Wald, the dissenting judge in the D.C. Circuit opinion in *Life Partners*, articulated three background principles to guide the analysis of whether an investment scheme is a security. *See* SEC v. Life Partners, Inc., 87 F.3d 536, 549-50 (D.C. Cir. 1996) (Wald, J., dissenting). The first principle is to avoid imposing overly formal restrictions on the determination of what constitutes a security, and "instead apply securities laws flexibly so as to achieve their remedial purpose." *Id.* at 549. The second principle is that the securities laws do not provide protection for all investments, just to those that meet the definition of "security." *Id.* at 550. The final principle is that the Securities Laws "embody the belief that information is the most important form of investor protection." *Id.*

152. *See infra* notes 161-270 and accompanying text.

153. 320 U.S. 344 (1943).

154. Although the statutory definition of "security" includes "fractional undivided interests in oil, gas or other mineral rights," the interests at issue in *Joiner* were not fractional undivided interests. *See Joiner*, 320 U.S. at 352. They were divided interests. *See id.* Accordingly, the SEC could not rely on the fractional interest part of the definition, and went on to successfully argue that such interests constituted "investment contracts." *See id.* at 351.

155. In determining whether a given investment was an investment contract, the *Joiner* court looked to "what character the instrument is given in commerce by

Three years later, the Court refined the definition of "investment contract" in the seminal case of *SEC v. W.J. Howey*.[156] In *Howey*, the Supreme Court held that if "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," the investment scheme is an investment contract for purposes of the Securities Act.[157] The *Howey* definition of investment contract "permits the fulfillment of the statutory purpose of compelling full and fair disclosure relative to the issuance of 'the many types of instruments that in our commercial world fall within the ordinary concept of a security.'"[158]

The Court's statement in *Howey* has been refined in the last half century, with little substantive change, into the test used by courts today to determine whether an investment scheme is a security for purposes of the Securities Act.[159] In the *Life Partners* case for example, the D.C. Circuit applied the *Howey* test to the sale of fractional interests in viatical settlements, holding that, to be classified as an investment contract, the fractional interests must involve an investment of money with the expectation of profits from a common enterprise that depended on the efforts of others.[160]

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the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect." *Id.* at 352-53.

156. 328 U.S. 293 (1946). In *Howey*, a Florida corporation that owned a fruit grove offered prospective investors land sales contracts for orchard land, as well as service contracts for harvesting and marketing. *See Howey*, 328 U.S at 295. The investors were required to engage some service provider in order to enter into the purchase land sales contracts; and while investors were permitted to make their own service arrangements for this required maintenance, the service company under common control with the offeror was heavily promoted to the investors. *See id.* at 302. The Court found this arrangement to constitute an investment contract for purposes of the Securities Act. *See id.* at 299.

157. *Id.*

158. *Id.* (citing H.R. REP. No. 73-85, at 11 (1933)). Additional support for this idea comes from *Tcherepnin v. Knight*, 389 U.S. 332 (1967), where the Court stated that "[i]n searching for the meaning and scope of the word "security" in the Act, form should be disregarded for substance and the emphasis should be on economic reality." *Id.* at 336 (citing *Howey*, 328 U.S. at 298).

159. "After half a century, Howey still states the test for determining the existence of an investment contract. In the intervening years, litigation has not focused on the correctness of the test, but rather on the precise meaning of one or more of its parts." Soderquist, *supra* note 140, at 134.

160. Some commentators and courts distill the *Howey* test into a four prong test: (1) an investment of money; (2) with the expectation of profits; (3) derived from the efforts of others; (4) in a common enterprise. *See* Miranda, *supra* note

C. *The D.C. Circuit Decision*

Life Partners appealed to the D.C. Circuit on several grounds.[161] In addition to the claim that the fractional interests in viatical settlements marketed by Life Partners were beyond the scope of the definition of "security" in the Securities Laws,[162] Life Partners claimed that viatical settlements were exempt from registration as insurance contracts,[163] and, in the alterna-

151, at 270; *see also* Shanah D. Glick, *Are Viatical Settlements Securities Within the Regulatory Control of the Securities Act of 1933?*, 60 U. CHI. L. REV. 957, 969 (1993). Whether a given court actually articulates the "investment of money" prong or not, it is uniformly acknowledged that all the elements of the test must be satisfied for an instrument to be considered a security. *See id.*

161. *See* SEC v. Life Partners, Inc., 87 F.3d 536, 538 (D.C. Cir. 1996).

162. Life Partners based its conclusions on a legal opinion from January 1994, issued by Professor David Lipton at Catholic University, to the effect that the viatical settlements it arranged should not be considered securities under the federal securities laws. *See SEC Files Fraud, Registration Claims Based on Sale of Death Benefit Interests*, SEC. REG. & L. REP., Sept. 2, 1994, at 1203; *see also LPI Characterizes SEC Lawsuit as Groundless,* BUS.WIRE, Aug. 31, 1994, at 1. Life Partners also relied on the only published commentary on the subject at that time, a University of Chicago Law Review article by Shanah Glick, concluding that viatical settlements were not securities. Ms. Glick has since been joined by many other learned colleagues in considering the issue, some of which have come to contrary conclusions. *See* Glick *supra* note 160; Deeley, *supra* note 12; Miranda, *supra* note 151; DePeri, *supra* note 4; Doerler, *supra* note 148.

163. Before reaching the issue of whether fractional interests in viatical settlements constitute securities, the court examined the issue of whether viatical settlements constitute insurance contracts, and thus fall within the exemption of § 3(a)(8) of the Securities Act. This subsection exempts:

> [a]ny insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia.

15 U.S.C. § 77c(a)(8) (1994).

On the insurance issue, Life Partners first argued that viatical settlements redistribute risks in the same manner as insurance contracts. It argued that the relevant risk is that the insured will outlive his or her life expectancy. Life Partners' second argument was that its viatical business was part of "the business of insurance" and thus, under the McCarran-Ferguson Act, "[n]o Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the insurance business." 15 U.S.C. § 1012(b) (1994). To bolster its argument, Life Partners cited to the various state statutes regulating viatical settlements as part of their insurance laws.

The D.C. Circuit affirmed the district court's determination that viatical settlements did not qualify for the § 3(a)(8) exemption. According to the district court, Life Partners did not "issue insurance policies or underwrite risk or undertake the normal activities of an insurance company." SEC v. Life Partners, Inc., tive, that the notes purchased by IRAs, collateralized by viatical settlements, were beyond the scope of the definition of security.[164] Because this Article focuses on the issue of whether fractional interests in viatical settlements are securities, detailed discussions of the insurance and IRA note issues are left for other commentators.

The D.C. Circuit applied *Howey* as a three-pronged test requiring (1) the expectation of profits arising from (2) a common enterprise that (3) depends on the efforts of others.[165] This Part

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898 F. Supp. 14, 19 (D.D.C. 1995). The "hallmark" of insurance is the spreading and underwriting of a policyholder's risk, unlike the situation with securities investments, where the risk is borne by the purchaser of the investment and not by the issuer. Thus, securities, unlike insurance policies, do not transfer or spread risk. *See id.* at 18. In viatical settlements, the investor assumes no market risk, only maturity risk— the possibility that the viator will outlive his life expectancy, thereby reducing the investor's return. However, this risk is inherent in every investment and does not serve what the court termed the "central purpose of insurance"— to transfer risk from the insured to the insurer. *Id.*

The D.C. Circuit agreed with the SEC that the fact that the asset underlying a viatical settlement is an insurance policy was irrelevant. *See* SEC v. Life Partners, Inc., 87 F.3d 536, 541 (D.C. Cir. 1996). The court concluded that Life Partners' offerings were not exempt under § 3(a)(8) and were not shielded from federal regulation by the McCarran-Ferguson Act; viatical settlements are not insurance policies and "the business of selling fractional interests in insurance polices is no part of the 'business of insurance.'" *Id.* at 542.

For additional discussion on the insurance issue, *see* Glick *supra* note 211, at 959-68; *see also* Timothy P. Davis, *Should Viatical Settlements Be Considered "Securities" Under the 1933 Act?*, 6 KAN. J.L. & PUB. POL'Y 75, 77-78 (1997); Deeley, *supra* note 12, at 397; DePeri, *supra* note 4, at 858.

164. Because the D.C. Circuit found that the viatical settlements marketed by Life Partners were not securities, and "because the essential characteristics of the investment are no different whether the purchaser is an IRA or an individual investor, the status of the notes under the 1933 Act does not require extended analysis. . . .we hold that the notes— like the viatical contracts for which they stand — are not securities." SEC v. Life Partners, Inc., 87 F.3d 356, 548-49 (D.C. Cir. 1996). A determination that fractional interests in viatical settlements are in fact securities would undermine this result, but that discussion is beyond the scope of this Article.

165. *See id.* at 542. Because this Article is, in part, an evaluation of the *Life Partners* decision and its implications, the Author has adopted the three pronged test used by the D.C. Circuit. The D.C. Circuit did not discuss the investment of money requirement as a separate prong, but rather as a necessary component of the expectation of profits. According to the district court, "[t]he parties to the instant case do not contest that the buyers of viatical settlements are investing money." SEC v. Life Partners, Inc., 898 F. Supp. 14, 19 (D.D.C. 1995). If a later court should revisit this issue and rely on a four pronged version of *Howey*, articulating the investment of money as a specific stand alone element, the ultimate conclusion would not be affected because viatical settlements satisfy the "invest-

examines each prong of the *Howey* test, and the relevant case law refining that prong. Then this Part applies the *Howey* test to the facts of *Life Partners*, and where appropriate, offers a critique of the D.C. Circuit's analysis.

1. Howey's *First Prong: the Expectation of Profit*

The first prong of the *Howey* test calls for an investment scheme that involves an expectation of profit.[166] This prong was refined by the Supreme Court in *United Housing Foundation v. Forman.*[167] According to the *Forman* court, the "touchstone" of the definition of security is "the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others."[168]

The *Forman* court held that shares in a state-subsidized and supervised nonprofit housing cooperative were not securities for purposes of the Securities Act, because the investors did not purchase the stock "in the hope of receiving profits from the efforts of others."[169] Rather, they purchased the shares as commodities to get the right to occupy units in the housing development, for their personal consumption or use.[170] So, after *Forman*, to satisfy the first prong of the *Howey* test, the investment must be motivated by an expectation of profits, and not solely by personal consumption or use.[171]

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ment of money" prong. An investor who participates in a viatical settlement advances money to the policyholder, with the expectation of a return on that investment. *See* Davis, *supra* note 163, at 79.

166. *See Life Partners*, 87 F.3d at 542. "By profits, the Court has meant either capital appreciation resulting from the development of the initial investment. . .or a participation in earnings resulting from the use of investors' funds. . . . In such case the investor is 'attracted solely by the prospects of a return' on his investment." United Housing Foundation v. Forman, 421 U.S. 837, 852 (1975).

167. 421 U.S. 837 (1975).

168. *Forman*, 421 U.S. at 852.

169. *Id.* at 858. In order to occupy an apartment in the housing cooperative, prospective investors had to acquire a certain number of shares of stock. As the Court said, "in effect, their purchase [of the shares] is a recoverable deposit on an apartment." *Id.* at 842.

170. "In the present case there can be no doubt that investors were attracted solely by the prospect of acquiring a place to live, and not by financial returns on their investments." *Id.* at 853.

171. *Id.* at 858.

The D.C. Circuit queried as to whether investors in viatical settlements have the requisite expectation of profit.[172] The court found that investors in Life Partners received an asset in the form of a claim on future death benefits of the viator. Viatical settlements are by their very nature unable to be "consumed" at the time of the investment.[173] They are simply unmatured rights to collect life insurance proceeds at an indeterminate future time after the investors commit funds to the investment. Investors pay some portion of the discounted present value of the policy, for the right to receive a financial return— their pro rata share of the full face value of the policy when it matures. Thus, the D.C. Circuit correctly determined that the sale of fractional interests in viatical settlements satisfied the first prong of the *Howey* test, because the investments were made in the expectation of profit.

2. Howey*'s Second Prong: Common Enterprise*

The second prong of the *Howey* test calls for a common enterprise.[174] The common enterprise requirement centers on the relationship between the investors, the investment, and the

172. The D.C. Circuit read the *Forman* gloss on *Howey* to say that "expected profits must, in conformity with ordinary usage, be in the form of a financial return on the investment, not in the form of consumption." SEC v. Life Partners, Inc., 87 F.3d 536, 543 (D.C. Cir. 1996).

173. According to the court, the investor "is obviously purchasing not for consumption—unmatured claims cannot be currently consumed— but rather for the prospect of a return on his investment." *Id.* at 543.

Life Partners encouraged investors' expectations of a return on their investments through its promotional materials, like its "Newsgram," which stated that "rates of return on viatical settlements consistently out perform market rates by a wide margin. . . the discount for the longer term commitments is higher, and therefore, the potential annual yield more attractive." SEC v. Life Partners, Inc., 898 F. Supp. 14, 20 (D.D.C. 1995).

174. *See Life Partners,* 87 F.3d at 542. One commentator, Michael Davis, breaks the common enterprise requirement of *Howey* into a "two-step determination that (1) investors share commonality and (2) an enterprise exists. If an investment contract fails to exhibit these criteria, it fails to satisfy the second prong of the *Howey* test and is not an investment contract constituting a security." According to Mr. Davis,

> the question of whether a common enterprise exists depends on whether the interest acquired by the investor is simply an interest in property and nothing more, or whether the property interest is an interest in an ongoing business enterprise and, thus, constitutes a security within the definition of the Act. Some courts ignore this new portion of the test, while others merge it into the third prong, giving the issue short shrift. In the interest of com-

promoter,[175] depending on which approach a court adopts to satisfy this requirement, horizontal commonality[176] or vertical commonality.[177] The Supreme Court had occasion to review these competing approaches and declined to choose one approach, leaving the different approaches in place in different jurisdictions.[178]

Under horizontal commonality, the investors' fortunes are joined in a pooling of interests.[179] The hallmarks of horizontal commonality are a pooling of resources, sharing of profits and sharing of losses.[180] Because horizontal commonality, unlike vertical commonality, is accepted as sufficient for this prong of the *Howey* test,[181] and because the sale of fractional interests in viatical settlements satisfies horizontal commonality,[182] no detailed discussion of vertical commonality and its application to fractional interests in viatical settlements is necessary or appropriate here.[183]

> pleteness and caution, this factor must be considered in all applications of the *Howey* test because it is gaining more widespread recognition.

Davis, *supra* note 41, at 937.

175. *See* Hazan, *supra* note 150, at 32.

176. Horizontal commonality has been adopted by the Third, Sixth and Seventh Circuits. *See* Doeler, *supra* note 148, at 257 (citing 2 LOSS & SELIGMAN, SECURITIES REGULATION 169 (3d ed. 1989)).

177. Vertical commonality requires that an investor's fortunes be inextricably interwoven with the fortunes of the promoter. *See* Gordon, *supra* note 117, at 643. Vertical commonality in turn breaks down into two subcategories: broad vertical commonality and narrow or strict vertical commonality. Broad vertical commonality has been recognized by the Fifth, Eighth, Tenth and Eleventh Circuits. Under this approach, all that is required is that the success or failure of the investor is dependent on, but not necessarily positively correlated with, the promoter's efforts. *See* Davis, *supra* note 163, at 81. Narrow vertical commonality is recognized by the Ninth Circuit. Under this approach, the success or failure of the investor must mirror the success or failure of the promoter; "their fortunes must rise and fall together." Davis, *supra* note 163, at 81.

178. *See generally* Mordaunt v. Incomco, 469 U.S. 1115 (1985).

179. *See* SEC v. Life Partners, Inc., 898 F. Supp. 14, 19 (D.D.C. 1995).

180. *See* SEC v. Life Partners, Inc., 87 F.3d 536, 543 (D.C. Cir. 1996).

181. *See id.* at 544; *see also* Hazan, *supra* note 150, at 33; Davis, *supra* note 163, at 81. Courts are divided as to whether vertical commonality will suffice on its own; *see* Deeley, *supra* note 12, at 392; *see also* Davis, *supra* note 41, at 939.

182. The D.C. Circuit agreed: "we conclude that all three elements of horizontal commonality — pooling, profit sharing, and loss sharing — attend the purchase of a fractional interest through LPI." *Life Partners*, 87 F.3d at 544.

183. The district court found both broad and narrow vertical commonality, in addition to horizontal commonality, in Life Partners' sale of fractional interests in viatical settlements. *Life Partners*, 898 F. Supp. at 20.

The D.C. Circuit evaluated whether fractional interests in viatical settlements satisfy the horizontal pooling approach to the common enterprise prong of the *Howey* test. The court looked for the three defining characteristics of horizontal commonality: pooling of investment funds, shared profits, and shared losses.[184]

The court found the requisite pooling because Life Partners involved multiple investors[185] and aggregated their invested funds to purchase the policies.[186] Thus, the completion of any one investor's purchase of a fractional interest was dependent on Life Partners finding investors to purchase the rest of the policy.[187]

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184. *See Life Partners*, 87 F.3d at 543.

185. The majority of Life Partners' business at the time of the litigation was in fractional interests in viatical settlements. Typically, Life Partners would attract 10 to 15 investors in a policy, but some policies had as many as 34 investors. *See* Brief of the SEC, Appellee at 10, SEC v. Life Partners, Inc., 898 F. Supp. 14 (D.D.C. 1995) (Nos. 95-5364 & 96-5018).

186. *See Life Partners*, 87 F.3d at 543. At least one commentator would disagree. Ms. Glick engages in a detailed analysis of the various kinds of viatical settlements including multiple purchaser brokered settlements and non-brokered settlements, and finds a lack of pooling in each case. She contends that the purchase of fractional interests in a policy is merely the sale

> of a fixed percentage interest of an insurance policy. . . The buyer purchases an intangible asset (the future right to a specific amount of money) and expects to receive profits derived from the value of that asset — not from a larger enterprise for which the asset is employed. The fact that several investors purchase a fixed percentage of the same policy does not convert individual asset sales into a common pool of invested funds. Each investor forwards her money to buy title to a percentage of an insurance policy. The transfer of title of that insurance policy is the substance of the transaction. It is not incidental, and it is not a proxy for an ownership interest in a related enterprise. There is no larger, related enterprise; hence, there is no pooling. Brokered viatical settlements therefore do not satisfy a horizontal commonality requirement.

Glick, *supra* note 160, at 977. Ms. Glick's point with respect to what she terms "non-brokered" viatical settlements, however, is well taken. In this scenario, when one investor buys an entire policy, there is no pooling of funds. Thus there is no horizontal commonality. *See* Glick, *supra* note 160, at 976; *see also* Davis, *supra* note 41, at 938.

187. *See Life Partners*, 87 F.3d at 543. Life Partners followed Ms. Glick's approach, claiming there was no pooling, and thus no shared profits or losses, because each investor acquired his or her own interest in the policy; further, there was no requirement that the entire policy be purchased. The court correctly focused on whether there is:

> a threshold percentage of a policy that must be sold before an investor can be assured that his purchase of a smaller percentage interest will be con-

The court also found the requisite sharing of profits and sharing of losses on a policy-by- policy basis.[188] Because Life Partners sold fractional interests in each policy, one investor could not realize a gain or loss in a given policy without each other investor in that same policy gaining or losing a proportionate amount. Since each investor owned a fraction of the policy, if the return on that policy was as good as or better than predicted, because the viator died on or prior to the expected date of death, each investor benefited in a pro rata fashion. Likewise, if the return were less than predicted, because the viator outlived his or her life expectancy, all investors in that viator's policy would share pro rata in such loss.

Thus, the D.C. Circuit correctly determined that the sale of fractional interests in viatical settlements satisfied the second prong of the *Howey* test, because the investments were made in a common enterprise.[189]

> summated. If not, then each investor's acquisition is independent of all the other investors' acquisitions and LPI is correct in asserting there is no pooling. On the other hand, if LPI must have investors ready to buy some minimum percentage of the policy before the transaction will occur, then the investment is contingent upon a pooling of capital.

Id. at 544. Based on Life Partners' own assertions that if it were somehow unable to sell a sufficient percent of a given policy, Life Partners would allow the investors to withdraw from the transaction, the court finds that "pooling is in practice an essential ingredient of the LPI program." *Id.*

188. *See id.* at 543. Life Partners unsuccessfully argued that to satisfy this prong of *Howey*, each investor's money had to be pooled with all of the other investors, so that all Life Partners investors' fortunes rose and fell together. The district court found pooling on a policy-by-policy basis to be sufficient to satisfy *Howey*. *See id.* at 544.

189. *See Life Partners*, 87 F.3d at 544. In a surprising argument, Life Partners claims that horizontal commonality, ordinarily sufficient to satisfy the common enterprise prong of *Howey*, was insufficient because of the lack of an "enterprise" in the scheme. The D.C. Circuit deferred discussion on this issue as part of the common enterprise prong, purportedly reserving consideration of this issue for its discussion of the third prong, involving profits deriving solely from the efforts of others. *See id.* Since the D.C. Circuit incorrectly found that the third prong was not satisfied, and thus the viatical settlements in question were not securities, the court never fully addressed this issue, saying only that "we see here no 'venture' associated with the ownership of an insurance contract from which one's profit depends entirely upon the mortality of the insured." *Id.* at 548. According to one commentator, it is therefore "unclear how this issue would have been resolved if the court had evaluated it within the context of the second prong of *Howey*." *See* Davis, *supra* note 41, at 954 n.162.

3. Howey's *Third Prong: Profits Derived From the Efforts of Others*

The third prong of the *Howey* test calls for the profits expected by the investor to be derived "from the efforts of others."[190] This requirement has been the subject of much debate, and, ultimately, some erosion in the case law.

Under *Howey*, the profits had to be secured "solely" from the efforts of others.[191] This requirement has been refined over time to include profits that come "primarily," "substantially" or "predominantly" from the efforts of others.[192] In *SEC v. Glenn W. Turner Enterprises*,[193] the Ninth Circuit relaxed the "solely" condition in *Howey* to an evaluation of "whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise."[194] The Ninth Circuit, in crafting this more flexible approach, was trying to avoid "unrealistic results" that would come from a dogmatic application of the "solely" from the efforts of others requirement.[195] Such a result would "frustrate the remedial purposes of the Act."[196] The Ninth Circuit's interpretation of this prong of the *Howey* test is consistent with the objectives of the Securities Laws, and was implicitly endorsed by the Supreme Court in *Forman*.[197]

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190. *See Life Partners*, 87 F.3d at 545.

191. *See* SEC v. W.J. Howey, 328 U.S. 293, 299 (5th Cir. 1946).

192. *See Life Partners*, 87 F.3d at 545; SEC v. Glenn W. Turner Enterprises, 474 F.2d 476, 481 (9th Cir. 1973); *see also* Hazan, *supra* note 150, at 31; SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 480 (5th Cir. 1974).

193. 474 F.2d 476 (1973).

194. *Turner*, 474 F.2d at 482.

195. *See id.* at 483. *Turner* involved a pyramid sales scheme in which investors purchased certain plans that were designed to help them sell the plans to others. *See id.* at 478. The investor had to sell at least some plans to others in order to realize a return on his own investment. *See id.* Accordingly, the original investor's profits were at least partially self-derived, and not derived "solely" from the efforts of others. *See id.* at 482.

196. SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 480 (5th Cir. 1974).

197. "The touchstone of the definition of security is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others." United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 852 (2d. Cir. 1975). Most of the Circuits have incorporated *Turner*'s more flexible approach. *See Koscot*, 497 F.2d at 477; *see also* Glick, *supra* note 160, at 972; Davis, *supra* note 41, at 944.

The D.C. Circuit has wisely followed the Ninth Circuit's approach and eliminated from this prong of the *Howey* test the rigid idea that the profits had to be derived "solely" from the efforts of others.[198] However, in *Life Partners*, the court adopted in its place an even more rigid idea, creating a bright-line test tied to the timing of these efforts.[199] Applying this bright-line test, the court found that fractional interests in viatical settlements did not satisfy the third prong of the *Howey* test, and accordingly were not securities. The court's arbitrary bright-line test creates an artificial distinction that is neither required by *Howey* or its progeny, nor supported by any case law precedent[200] or the history and objectives of the Securities Laws.[201]

The threshold legal question facing the D.C. Circuit was whether the court could consider all of Life Partners' efforts, or only their efforts after the investment in the viatical settlement had been made. Regardless of the modifier a particular court applies to describe the degree to which profits must flow from the efforts of others, the third prong of the *Howey* test requires an examination of the efforts of the investors and promoters to determine exactly whose efforts generated the profits, and to what degree they did so. Accordingly, the pre- versus post-purchase efforts question will be considered, following a discussion of the efforts Life Partners actually undertook in the various versions of its viatical investment programs.[202]

Life Partners engaged in substantial pre-purchase efforts that concerned "all aspects of finding and evaluating policies."[203] These efforts included: locating potential viators, evaluating the policyholder's medical condition and reviewing the terms of the policy by offering its "diligence and expertise in discovering and evaluating the legal status of an insurance policy and the in-

198. In *SEC v. Int'l Loan Network, Inc.*, 968 F.2d 1304 (D.C. Cir. 1992), the court found an investment contract where the profits came "predominantly" but not "solely" from the efforts of others. *See id.* at 1307.

199. The bright-line rule is that "whatever the surrounding circumstances, an investment is not a security unless significant managerial activities by the promoter occur post-purchase." SEC v. Life Partners, Inc., 87 F.3d 536, 551 (D.C. Cir. 1996) (Wald, J., dissenting).

200. *See infra* note 254.

201. *See supra* notes 136-52.

202. These efforts by Life Partners include efforts made on its behalf by its agent, Sterling Trust, in some cases. *See Life Partners*, 87 F.3d at 540.

203. SEC v. Life Partners, Inc., 898 F. Supp. 14, 17 (D.D.C. 1195).

sured's medical condition before offering it for investment,"[204] negotiating the purchase price, and preparing and executing certain legal documents.

Life Partners also engaged in post-purchase efforts in some or all of the versions of its viatical programs.[205] Life Partners claimed to offer "a comprehensive package of additional services,"[206] including: monitoring the insured's medical condition;[207] insuring that the premiums were paid so that the underlying policy did not lapse;[208] converting group policies into individual policies; handling all efforts relating to the collection and distribution of the proceeds of the policies, including submitting claim forms, accepting payment and paying out the pro rata shares of the proceeds; threatening, initiating and defending litigation when necessary;[209] and, most importantly, creat-

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204. *Id.* at 21.

205. *See supra* notes 130-35 for a discussion of the various viatical programs offered by Life Partners.

206. *See* Brief of the SEC, Appellee at 2, SEC v. Life Partners, Inc., 898 F. Supp. 14 (D.D.C. 1995) (Nos. 95-5364 & 96-5018).

207. According to Life Partners, this was accomplished by calling the viator's attending physician to see if the viator kept his or her most recent appointment. If the viator missed the appointment, Life Partners attempted to determine if the viator had died by contacting associates of the viator. *See* Plaintiff SEC's Brief in Support of Motion for Preliminary Injunction and Other Provisional Relief at 10-11, SEC v. Life Partners, Inc., 898 F. Supp. 14 (D.D.C. 1995) (No. 1:94CV01861).

208. "For those policies without a premium waiver, Sterling Trust pays premiums periodically out of funds escrowed for that purpose. If the escrowed funds are exhausted, Sterling Trust collects additional funds from investors for the payment of premiums." Brief of the SEC, Appellee at 14, SEC v. Life Partners, Inc., 898 F. Supp. 14 (D.D.C. 1995) (Nos. 95-6364 & 96-5018).

These efforts were the basis for the SEC's unsuccessful 1997 Motion Seeking Leave to Amend Complaint. According to the SEC, viators were outliving the period for which premiums had been reserved, and in some cases, the reserves for premiums were exhausted prematurely. The SEC asserted that Life Partners was advancing premium payments to issuers and then seeking reimbursement from viatical settlement investors, thus engaging in entrepreneurial post-purchase efforts that satisfy the third prong of the *Howey* test. The district court was unconvinced and denied the motion. *See* SEC v. Life Partners, Inc., 986 F. Supp. 645, 647-48, (D.D.C. 1997).

209. According to the SEC:

> LPI also reserves the authority to 'take such actions as are necessary to preserve and protect [investors'] ownership rights, including actions relating to conversion of group policies to individual policies.' Upon learning that an insured has died, LPI or Sterling Trust obtains the death certificate, submits a claim to the insurance carrier for the death benefit, and distributes the proceeds to investors. When disputes arise regarding the collection of death benefits from a life insurance company, LPI 'assume[s] an adversarial

ing a secondary market in viatical settlements by arranging the resale of the investor's interest when requested and feasible.[210]

The sum of these pre- and post-purchase efforts, on behalf of passive investors in viatical settlements who were dependent on Life Partners' expertise, constitute sufficient evidence of managerial or entrepreneurial efforts to satisfy this prong of the *Howey* test.[211] Yet, when the D.C. Circuit evaluated Life Partners' programs against its new bright-line "when did the efforts occur" test, it concluded that none of the versions reflected the necessary link between the profits and the efforts of others. The court's misguided reliance on its artificial bright-line test results in a legally insupportable conclusion.

The D.C. Circuit examined Life Partners' post-purchase efforts in all three versions of its viatical settlement programs, distinguishing between those efforts that were ministerial in nature, and thus insufficient for purposes of the *Howey* test, and those that were entrepreneurial in nature, and thus sufficient for purposes of the *Howey* test. The court found no significant entrepreneurial efforts on the part of Life Partners.[212] Even if

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> role with respect to that company and even threaten[s] the filing of a lawsuit in order to protect its beneficial owners' rights.' Defendants have in fact initiated and defended lawsuits on behalf of their investors.

Brief of the SEC, Appellee at 14, SEC v. Life Partners, Inc., 898 F. Supp. 14 (D.D.C. 1995) (Nos. 95-5363 & 96-5018). *See also* Capital Bankers Life Insurance Company v. Life Partners Inc., No. 94-CV-73458-DT, 1995 U.S. Dist. LEXIS 8734 (ED Mich. Apr. 28, 1995); DeRiggi and Life Partners Inc. v. Legacy Benefits Corp., No. 94 Civ. 9678 (DC), 1995 U.S. Dist. LEXIS 18734, at *1 (S.D.N.Y. Dec. 18, 1995).

210. With respect to the secondary market, Life Partners represented to its investors that it "had never failed to place a policy [in the resale market] in the years [it has] been in business, and offered the assurance that "if present market conditions continue (and we see no reason why they wouldn't) the policies will be immediately repurchased." Brief of the SEC, Appellee at 35, SEC v. Life Partners, Inc., 898 F. Supp. 14 (D.D.C. 1995) (Nos. 95-5364 & 96-5018). The promise of a resale market is more critical with respect to the portion of Life Partners' settlements that cover insured with life expectancies exceeding 24 months.

211. Life Partners and Pardo handled all aspects of evaluating and acquiring the insurance policies underlying the investment contracts and handled "all the managerial tasks essential to the success of the enterprise." *See SEC Files Fraud, Registration Claims Based on Sale of Death Benefit Interests*, SEC. REG. & L. REP., Sept. 2, 1994, at 1203, 1205.

212. *See* SEC v. Life Partners, Inc., 87 F.3d 536, 546 (D.C. Cir. 1996). The dissent disagreed, considering Life Partners' promise "to assist with the resale of the policies combined with its emphasis on the availability of resale opportunities to constitute managerial post-purchase activities." Since this feature was elimi-

this were true, the court failed to recognize that some nominally pre-purchase entrepreneurial efforts transcend the closing date and essentially function as post-purchase entrepreneurial efforts. The investors' initial dependence on Life Partners' expertise continues after the investment, in that investors must rely on Life Partners to monitor and protect their investment. In the absence of required disclosures under the Securities Laws, this reliance may be to their detriment.[213]

Version I[214] satisfied the third prong of the *Howey* test, for three reasons. First, either Life Partners or Sterling Trust was listed as the record owner of the policy, and thus had the ability, after the purchase closed, to change the beneficiary. This tied the fortunes of the investors even more closely to Life Partners, because the investors were now dependent on Life Partners to deal with them honestly and in good faith.[215] Yet the D.C. Cir-

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nated from Versions II and III, the dissent finds the point immaterial. *See id.* at 551 (Wald, J., dissenting).

213. Investors passively depend on Life Partners to select a good investment from a myriad of life insurance policies covering the lives of unique individuals, each with particular medical circumstances; Life Partners is legally free to make whatever representations it desires to potential investors, without Securities Act liability.

The SEC was concerned about representations Life Partners made to potential investors that an "independent reviewing physician" examines viators' medical records and calculates a life expectancy. It turns out that Dr. Kelly, the "independent reviewing physician" was really a family practice physician with very limited experience treating AIDS. Additionally, the doctor was a director and shareholder of Life Partners and was paid by Life Partners for his evaluations only if he determined that the viator qualified for viatication by Life Partners, and if Life Partners actually purchased the policy. Because its investors were denied the protection of the Securities Laws, Life Partners was not required by any federal law to disclose Dr. Kelly's relationship with Life Partners, his experience level in treating AIDS and his contingency fee arrangement. *See* Plaintiff SEC's Brief in Support of Motion for Preliminary Injunction and Other Provisional Relief at 16, SEC v. Life Partners, Inc., 898 F. Supp. 14 (D.D.C. 1995) (No. 1:94CV01861s); *see also* Brief of the SEC, Appellee at 39, SEC v. Life Partners, Inc., 898 F. Supp. 14 (D.D.C. 1995) (Nos. 95-53d64 & 96-5018).

214. *See* notes 130-35 for a discussion of the various versions of Life Partners' viatical programs.

215. A further implication of Life Partners or Sterling Trust listed as the record owner, instead of the investors, was the possibility that creditors of Life Partners or Sterling Trust might have access to the policies, if either entity experienced financial difficulties. So, in another very real way, the investors' profits were dependent on Life Partners remaining in financial good health. *See Life Partners*, 898 F. Supp. at 22; *see also Life Partners*, 87 F.3d at 551 (Wald, J., dissenting).

cuit was not persuaded that this created a sufficient connection between the investors' profits and Life Partners' efforts.[216]

In addition, Version I satisfied the third prong of the *Howey* test because its investors were essentially passive and the realization and magnitude of any profits depended predominantly upon the efforts of Life Partners for pre-purchase expertise and the efforts of Life Partners or Sterling Trust for post-purchase management of the investment.[217] Even if the investors knew the procedures, the record owner of the policy (i.e., Life Partners or Sterling Trust) would need to be involved in filing for the death benefits, making any profits predominantly derived from the efforts of Life Partners or Sterling Trust.[218]

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216. According to the court, the "promoter's 'efforts' not to engage in criminal or tortious behavior and not to breach its contract are not the sort of entrepreneurial exertions that the *Howey* Court had in mind when it referred to profits arising from 'the efforts of others.'" *Life Partners*, 87 F.3d at 545.

217. In its promotional materials, Life Partners emphasizes that after the investors have singed the "Agency Agreement and Special Power of Attorney" and the "Policy Funding Agreement," and written a check for their *pro rata* portion of the policy, the investors have no further obligations with respect to the investment; Life Partners promises to take care of everything else. *See* Plaintiff SEC's Brief in Support of Motion for Preliminary Injunction and Other Provisional Relief at 9-10, SEC v. Life Partners, Inc., 898 F. Supp. 14 (D.D.C. 1995) (No. 1:94CV01861).

218. According to the SEC:

> [t]he undisputed facts establish that the ongoing efforts of the defendants and their surrogates following the sale of death-benefit interests to investors are essential to the investors' realizing a return. A Life Partners investor left on his own would encounter a host of problems stemming from the fact that he is a stranger to the insured, the insurance company that issued the policy, and the other investors who bought interests in the death benefits under the policy. An investor thus would not know when his rights "matured," i.e., when the insured died. Indeed, having had no previous contact with the insured or the insured's agent, he could not readily determine whether the insured was alive or dead. Assuming that an investor somehow learned of the insured's death and documented it properly, he would then be confronted with the problem of making a claim under an insurance policy of which he was neither the owner nor the beneficiary. He would also be confronted with the problem of identifying the other investors who bought interests in death benefits under the policy and determining who was entitled to what portion of the proceeds. The problems would be even more acute for an investor who bought an interest in a policy of longer "maturity" in reliance on LPI's undertaking to make a secondary market in them.

Plaintiff SEC's Post-Hearing Brief in Support of Motion for Preliminary Injunction and Other Provisional Relief and in Opposition to Defendants' Motion to Dismiss at 2-3, SEC v. Life Partners, Inc., 898 F. Supp. 14 (D.D.C. 1995) (No. 1:94CV01861 (JHP)).

Finally, Version I satisfied the third prong of the *Howey* test because Life Partners negotiated the purchase price of the policy with the viator, connecting the investors' profits with Life Partners' efforts. However, the D.C. Circuit did not find a sufficient connection between the investors' profits and Life Partners' "efforts." The court myopically fixated on the idea that the life span of the viator was the sole determinant of the investors' profits. According to the court, even as record owners, Life Partners or Sterling Trust would be unable to have any impact on the "near exclusive determinant of the investors' rate of return, namely how long the insured survives."[219] However, much more goes into the profitability of these investments than simply the date of the viator's death.[220] The initial price paid for the policy, which is negotiated and set by the experts at Life Partners, based on their knowledge of the viatical market and of the life expectancies of AIDS patients,[221] is a material factor.

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219. SEC v. Life Partners, Inc., 87 F.3d 536, 545 (D.C. Cir. 1996).

220. According to the SEC:

> LPI's efforts, moreover, are essential to the success or failure of the investment. Although the death benefit under any given policy is a fixed amount, the value of an investment with LPI varies as a function of the longevity of the insured and the length of time it takes after the insured's death for the investor to realize his *pro rata* share of the death benefits. LPI's efforts affect the value of the investment at each step in the process, first when it applies its claimed expertise in identifying insured who will die sooner rather than later and whose insurance policies are valid and transferable; then when it undertakes to determine in a timely fashion whether the insured has, in fact, died; then when it obtains the death certificate and submits the claim to the insurance company; and finally when it distributes the proceeds to the investors.

Plaintiff SEC's Brief in Support of Motion for Preliminary Injunction and Other Provisional Relief at 23, SEC v. Life Partners, Inc., 898 F. Supp. 14 (D.D.C. 1995) (No. 1:94CV01861).

221. According to Mr. Pardo, investors do not participate in price negotiations with the viator, because the policy is not offered to investors for purchase until the seller and Life Partners have settled on a price. Thus, investors:

> rely on Life Partners, with its familiarity with going rates and prominence as a major viatical company, to obtain a favorable purchase price. Any delay in obtaining benefits after the insured dies, for example if a former beneficiary or the insurance company challenges the assignment, cuts into profits. Hence, Life Partners' services of investigating policies, drafting valid assignment contracts, and arranging if necessary for former beneficiaries to agree to the assignment, is also very important. In addition, policy sellers in some states may have enhanced protections and revocation rights, and some states may not recognize the purchase of policies by persons without an insurable interest. As a result, investors must rely on Life Partners' knowl-

In fact, the negotiation of the price, normally completed pre-purchase, is a factor that continues to resonate beyond the closing of the investment, and functions as a post-purchase entrepreneurial effort. Thus, in Version I, the profits from the viatical settlements were predominantly derived from the efforts of Life Partners and/or Sterling Trust, who in any event constitute "others,"[222] thereby satisfying the third prong of the *Howey* test.

Version II[223] also satisfied the third prong of the *Howey* test, because of Life Partners' role as market maker for viatical settlements. The investors were listed as the record owners of the policies instead of Life Partners or Sterling Trust, but Life Partners continued to provide post-purchase services, which it characterized as ministerial in nature.[224] However, these services, particularly the creation of a secondary market for viatical settlements, were not simply ministerial in nature.[225] By establishing a resale market, Life Partners inexorably linked the profitability and liquidity of the investments it was selling to the success of its own efforts in the resale market. This is especially true for investors who purchased policies from viators with longer life expectancies, and thus would presumably be more likely to avail themselves of such a resale opportunity because of the greater time period until the investment matures.

> edge of insurance laws in the different states and Life Partners' tracking of proposed legislation affecting viatical settlements.

Life Partners, 87 F.3d at 555 (Wald, J., dissenting).

222. According to the district court, "[i]t is not dispositive that some of the activities are carried out by an escrow agent acting on LPI's instructions. Nothing in *Howey* requires the efforts of others to be exclusively those of the issuer or promoter." SEC v. Life Partners, Inc., 898 F. Supp. 14, 22, n.11 (D.D.C. 1995).

223. *See* notes 130-35 for a discussion of the various versions of Life Partners' viatical programs.

224. *See Life Partners*, 87 F.3d at 545.

225. Life Partners held itself out as standing ready to repurchase policies issued on viators with longer life expectancies:

> LPI also undertakes to reevaluate the insured's medical condition each year in conjunction with the insured's attending physician and Dr. Kelly to assist investors in deciding whether to hold or sell their interests. LPI represents to investors that it can resell such investments at prices that will yield the original investors an annualized return of 15 to 30 percent.

Plaintiff SEC's Brief in Support of Motion for Preliminary Injunction and Other Provisional Relief at 12, SEC v. Life Partners, Inc., 898 F. Supp. 14 (D.D.C. 1995) (No. 1:94CV01861).

This service functions as an entrepreneurial post-purchase service.

The D.C. Circuit, however, was unconvinced of the importance of resale opportunities, apparently because there was nothing in the record to indicate that investors actually sought to liquidate their investments prior to the receipt of death benefits.[226] The court noted that it saw no evidence that Life Partners' assistance would add value to the investment contract, claiming that investors could get the same resale help from any other viatical settlement firm.[227] Further, Life Partners specifically warned its clients that viatical settlement transactions were not liquid assets, and that there was no established resale market.[228] Thus, the court held that "LPI's promise of help in arranging for the resale of a policy is not an adequate basis upon which to conclude that the fortunes of the investors are tied to the efforts of the company, much less that their profits derive 'predominantly' from those efforts."[229]

Nothing said by the court eliminates the possibility, and in the case of policies covering viators with longer life expectancies, the probability, that Life Partners' holding itself out as a market maker for viatical settlements played a role in the decision to invest. Life Partners agreed to make a secondary market. The fact that the court did not find evidence that anyone had yet availed themselves of this entrepreneurial post-purchase service does not mean that the investors failed to take that service into account in deciding to make the investment—in determining what their exposure and return were likely to

226. *See Life Partners*, 87 F.3d at 546. However, as the Supreme Court said in *Howey*, it is sufficient that the promoter "offer the essential ingredients of an investment contract." SEC v. W.J. Howey Co., 328 U.S. 293, 301 (5th Cir. 1946); *see also* Plaintiff SEC's Reply Brief in Support of Motion for Preliminary Injunction and Other Provisional Relief and in Opposition to Defendants' Motion to Dismiss at 11, SEC v. Life Partners, Inc., 898 F. Supp. 14 (D.D.C. 1995) (No. 1:94CV01861 (JHP)).

227. *See Life Partners*, 87 F.3d at 546. The SEC maintained that this holding is "directly in conflict with decisions of the Supreme Court and this Court. It has long been recognized that the mere fact that investors might make their own arrangements for the provision of certain services does not negate their dependence on the promoter's efforts." Petition of SEC for Rehearing and Suggestion for Rehearing *En Banc* at 14, SEC v. Life Partners, Inc., 898 F. Supp. 14 (D.D.C. 1995) (Nos. 95-5364, 96-5018 & 96-5090).

228. *See Life Partners*, 87 F.3d at 546.

229. *Id.*

be. The very fact that Life Partners advertised that it would assist in the resale if requested adds value to the investment—the possibility of an exit strategy from an otherwise illiquid asset. Absent questioning the actual investors, quantifying that value is impossible, but it is naive to simply write this factor out of the investment equation.[230] Thus, in Version II, the profits from the viatical settlement investments were predominantly derived from the efforts of Life Partners and/or Sterling Trust, satisfying the third prong of the *Howey* test.

Version III[231] satisfied the third prong of the *Howey* test, because investors had to rely on Life Partners' expertise to identify the viatical settlement investment opportunities and to realize the payout on the policies. In Version III, Life Partners claimed to provide no post-purchase support, serving as the basis for the D.C. Court's holding that the fractional interests in viatical settlements were not securities.

Of all of Life Partners' services, those most important to the return on the investment were the selection of viators[232] and the

230. Without Life Partners to create a secondary market, the investors will effectively be unable to liquidate their investments. There is no other secondary market for viatical settlements. So, if Life Partners gets into financial trouble, or goes out of business, its investors are denied what could have been a significant factor in their view of the profitability of this investment— the chance for liquidity. *See* Brief of the SEC, Appellee at 35, SEC v. Life Partners, Inc., 898 F. Supp. 14 (D.D.C. 1995) (Nos. 95-5364 & 96-5018) (citing Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 756 F.2d 230, 240 (2d Cir. 1985)).

According to the SEC:

> while an investor who must either hold the investment until "maturity" or who liquidate on his own might realize a negative rate of return (relative to market rates), the defendants promote their resale mechanism as a means of providing high returns.

Id.

231. *See* notes 130-35 for a discussion of the various versions of Life Partners' viatical programs.

232. According to the SEC:

> In its promotional materials, LPI represents that, in selecting policies, it carries out 'months of research and due diligence' and 'conducts an exhaustive legal and medical review to assure [LPI's] underwriting criteria is [sic] fully complied with.' According to LPI's promotional materials, LPI 'extensively evaluates the medical condition of the 'Viaticator' [i.e., the insured] from three principle [sic] sources': (1) the insured's medical records (which he must release to LPI) and an 'extensive questionnaire' filled out by the insured regarding his medical history; (2) a 'thorough medical questionnaire' completed by the insured's attending physician 'providing detailed information on the progress of the patient's condition, all related diseases to

pricing of the viatical settlements. These efforts in a real sense determined the ultimate return on the investment. Admittedly, Life Partners cannot control when the viators die, but it certainly does control how it prices the settlements, based on its expert evaluation of the viator's life expectancy.[233] Investor profits depend on whether the viator dies within the period estimated by the experts at Life Partners.[234] Its nominally pre-purchase selection, negotiation and pricing efforts resonate beyond the closing of the sale of the fractional interests in the viatical settlements to function as entrepreneurial post-purchase efforts.[235]

Investors rely on Life Partners' expertise in selecting policies for viatication. Investors new to the viatical settlement industry may know nothing of AIDS or any other terminal illness suffered by viators. Data such as T-cell counts and viral loads would offer such investors essentially no usable information on

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> the AIDS condition, treatments and prognosis,' and the physician's certification that the insured is mentally competent; and (3) a review of 'all relevant medical records' conducted by LPI's 'independent reviewing physician,' based on whose estimate of the insured's life expectancy LPI 'evaluate[s] the anticipated term of the policy holding period.

Plaintiff SEC's Brief in Support of Motion for Preliminary Injunction and Other Provisional Relief at 7, SEC v. Life Partners, Inc., 898 F. Supp. 14 (D.D.C. 1995) (No. 1:94CV01861).

233. According to the dissent:

> [w]hether investors realize the profits they expect depends on whether LPI's estimation of the insured's life span is accurate. The longer the insured remains alive, the lower the investors' profits, particularly if premiums must continue to be paid. Moreover, the record clearly supports the district court's finding that investors rely on LPI's evaluation of the insured's life expectancy. LPI emphasizes the detailed assessment of the insured's medical condition that it performs in its promotional matures. While the T-cell count of a person with AIDS is an important indicator of life expectancy, LPI's reviewing physician testified that he bases his life expectancy estimates on several other factors as well, such as incidence of opportunistic infections, platelet count, pulmonary studies, etc. Potential advances in the treatment of AIDS must also be taken into account.

SEC v. Life Partners, Inc., 87 F.3d 536, 555 (D.C. Cir. 1996) (Wald, J., dissenting).

234. *See id.* at 556 (Wald, J., dissenting).

235. This idea has support in the dissent: Judge Wald disagrees that all investments based on just pre-purchase managerial efforts should be outside the definition of security; she believes the third prong can be met by pre-purchase managerial activities when "it is the success of these activities, either entirely or predominantly, and not the market, that determines whether profits are eventually realized. The pre-purchase activities must be directed at the sale of the investment opportunity." *Id.* at 551 (Wald, J., dissenting).

which to make their investment decision. Such investors would naturally rely on Life Partners' expertise in selecting and evaluating the policies and in pricing the viatical settlements, efforts the D.C. Court incorrectly characterized as purely pre-purchase in nature, ignoring the continuing role such efforts played in the post-purchase period.[236] Investors' profits depend predominantly on Life Partners' expertise in negotiating the purchase price for the policy. As the dissent said, "whether investors realize the profits they expect depends on whether LPI's estimation of the insured's life span is accurate."[237]

Life Partners argued that "its pre-purchase functions are wholly irrelevant and that the post-purchase functions, by whomever performed, should not count for *Howey* because they are only ministerial."[238] Life Partners makes the unrealistic claim that, since it ceased performing any post-purchase services and purportedly ceded such services to investors, the investors could now undertake all necessary post-purchase functions. Even if the investors had the legal right, or obligation, to undertake the post-purchase efforts previously undertaken by the experts at Life Partners, most, as a practical matter, would be unwilling,[239] or perhaps unable[240] to do so. As the district court

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236. *See id.* at 548. Life Partners investors typically do not see any of the medical information provided by the viators to the viatical settlement firm; rather, they "rely on representations made by LPI and its sales representatives that the insured and the policy meet LPI's criteria." *See* Plaintiff SEC's Brief in Support of Motion for Preliminary Injunction and Other Provisional Relief at 9, SEC v. Life Partners, Inc., 898 F. Supp. 14 (D.D.C. 1995) (No. 1: 94CV01861). Presumably, the investors are to take it on faith that these criteria are somehow a sufficient basis to commit funds to the investment. *See supra* note 213.

> Although investors can ask for a copy of the report on the insured's medical condition filed by LPI's reviewing physician, they can only review the medical information supplied by the insured and the insured's physician in LPI's offices. Nor do they have any access to medical information on the insured beyond that obtained by LPI. . . In any event, given the technical and complicated nature of this medical information, few investors are likely to be able to assess the reliability of LPI's life expectancy estimate.

Life Partners, 87 F.3d. at 555 (Wald, J., dissenting).

237. *Id.* at 555 (Wald, J., dissenting).

238. *Id.* at 545.

239. According to the SEC:

> Although in theory other persons might perform these services, they are, as the district court found, performed by defendants or their agents. The vast bulk of defendants' business involves the sale of fractional interests — as little as 3% — of an insurance policy. Any such investor seeking to perform

said, "it is neither realistic or [sic] feasible for multiple investors, who are strangers to each other, to perform post-purchase tasks without relying on the knowledge and expertise of a third party."[241]

> these services would have to coordinate with all of the other investors on the policy, and would of course have to undertake considerable added expense (and a commensurate lower return) to do so.

Petition of the SEC for Rehearing and Suggestion for Rehearing *En Banc* at 13, SEC v. Life Partners, Inc., 898 F. Supp. 14 (D.D.C. 1995) (Nos. 95-5364, 96-5018 & 96-5090).

240. Under some state statutes, only licensed viatical settlement providers are authorized to contact the insured to check on their health, and then only at specific intervals. *See* 28 TEX. ADMIN. CODE § 3.10012 (West 1996). However, a small investor in a life insurance policy needs the post-purchase assistance of a licensed viatical settlement firm to learn of the viator's death, information that is critical to realizing a return on the investment.

This regulation obviously benefits viators, who, in the throes of their illness, could likely do without the vulture-circling phone calls. For example, Kendall Morrison used a broker to viaticate several life insurance policies five years ago when he was "extremely sick — wasting, unable to retain food, in diaper." Morrison's health began to improve in response to a regime including protease inhibitors. The investor in one of his policies became impatient, sending him federal express queries about his health. According to Morrison, it was as if the investor was asking, "are you still alive?" Morrison moved and changed his phone number in an effort to avoid the investor's queries. The investor threatened to sue the viatical broker for fraud and breach of contract because after 5 years, Morrison was still alive. The broker agreed to repurchase the policies to avoid a lawsuit and to spare Morrison additional grief. *See Still Waiting*, N.Y. TIMES, July 19, 1998, at 11; *see also* Sandal, *supra* note 46; *see also* Stephen Rae, *Die, Damn You — I've Got Money On It*, THE INDEPENDENT, Aug. 2, 1998, at 14.

Moreover, in some cases, performing the post-purchase activities might be impossible. At least one version of Life Partners' promotional materials stated that that the option to take over post-sale functions was only possible if the buyer owned the entire policy. *See* Brief of the SEC, Appellee at 43, SEC v. Life Partners, Inc., 898 F. Supp. 14 (D.D.C. 1995) (Nos. 95-5364 & 96-5018).

241. SEC v. Life Partners, No. 94-1861 (RCL), 1996 U.S. Dist. LEXIS 3451, at *2 (D.C. Cir. March 19, 1996). The SEC agreed:

> It simply is not feasible for multiple investors, who are strangers to each other, to profit from the purchase of fractional interests in viatical settlements without delegating responsibility for "post-closing" tasks to someone who possesses the knowledge, skill, and expertise needed to perform them. Without the assistance of such a third party, how are a dozen or twenty or thirty strangers who happen to own fractional interests in the death benefits under a given policy going to convert a group policy to an individual policy if the insured loses his job and ceases to be a member of the covered group? [M]onitor the insured to determine when he dies? [D]ocument his death once it occurs? [S]ubmit a claim to the insurance company? [I]nstruct the insurance company as to how the payment of benefits should be made? [A]ttend to the initiation and prosecution of claims against the insurance

While the D.C. Circuit agreed with the district court that these efforts were "undeniably essential to the overall success of the investment,"[242] it would not allow these "essential" efforts of locating and evaluating the medical condition of potential viators, and negotiating a purchase price, to count towards satisfying the *Howey* test simply because they occurred prior to the purchase.[243] The court applied its rigid and precedentially unsound bright-line rule to discount the "essential" quality of these efforts,[244] despite the fact that the Supreme Court never drew a bright-line distinction in *Howey* between pre- and post-purchase efforts, and despite the fact that these nominally pre-purchase efforts have an ongoing importance to the success or failure of the investment.[245]

> company if benefits are not paid in accordance with the policy? It is self-evident that the majority of such investors will remain passive and will rely on some third party to perform the necessary tasks to obtain a pay-out.

Emergency Motion of Plaintiff SEC for Supplemental Provisional Relief at 4-5, SEC v. Life Partners, Inc., 898 F. Supp. 14 (D.D.C. 1995) (No. 94-1861 (RCL)).

242. SEC v. Life Partners, Inc., 87 F.3d 536, 547 (D.C. Cir. 1996).

243. *See id.* at 547-48; *see also* Petition of the SEC for Rehearing and Suggestion for Rehearing *En Banc* at 2, SEC v. Life Partners, Inc., 898 F. Supp. 14 (D.D.C. 1995).

> The majority's disregard of pre-purchase efforts is especially troubling when considered in light of the principle that efforts are relevant only if they are the "predominant" source of the investors' profits. In any investment involving the securitization of an asset, the predominant determinant of profits will almost always be the skill of the promoter in selecting the asset in the first place, something which typically will occur pre-purchase.

Id.

244. The court ignored the economic reality of these investments and found that investors' profit "depends entirely upon the mortality of the insured" and that "the SEC is unable to show that the promoter's efforts have a predominant influence upon investors' profits." *Life Partners*, 87 F.3d at 548. *See* Petition of the SEC for Rehearing and Suggestion for Rehearing *En Banc* at 8, SEC v. Life Partners, Inc., 898 F. Supp. 14 (D.D.C. 1995).

According to the SEC, it would be "hypertechnical. . .to discount the importance of LPI's pre-purchase entrepreneurial functions simply because they occur before the moment of closing." *Life Partners*, 87 F.3d at 547.

245. The post-purchase efforts of LPI are not merely ministerial.

> Defendants themselves concede that post-sale evaluation and monitoring of insured's health require sensitivity (in some states, legislation or proposed legislation "restricts contact with the insured"); it also requires medical knowledge and skill, especially in situations where LPI uses the medical information to aid investors in deciding whether to retain or sell their investments. Many of the other tasks require extensive detailed knowledge about insurance policies, litigation, and other specialized areas. And many

According to the D.C. Circuit, in order for *Howey*'s third prong to be met, the promoter must perform managerial and entrepreneurial efforts after the investment is purchased.[246] Certainly, the third prong of the *Howey* test is satisfied in such a situation, but this is not the only such scenario that satisfies the *Howey* test.[247] Under the D.C. Circuit's new and unique bright-line test, an "undeniably significant" action undertaken by the promoter immediately after the purchase would satisfy the *Howey* test, yet the identical action taken immediately prior to the purchase would not.[248] This bright-line rule establishes a

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> of these efforts required coordinating among as many as thirty or more investors in a single policy.

Appellee's Brief at 44, SEC v. Life Partners, Inc., 898 F. Supp. 14 (D.D.C. 1995) (Nos. 95-6364 & 96-5018).

> It is true, as the panel majority notes that in other cases where pre-purchase efforts were considered, those courts also found significant post-purchase efforts. But the majority does not explain why pre-purchase efforts that are considered significant in conjunction with post-purchase efforts should lose all significance when considered in isolation.

Petition of the SEC for Rehearing and Suggestion for Rehearing *En Banc* at 10-11, SEC v. Life Partners, Inc., 898 F. Supp. 14 (D.D.C. 1995).

246. *Life Partners*, 87 F.3d at 548.

247. The dissent proposes that compliance with this third prong of *Howey* be determined by: "focusing on the kind and degree of dependence between the investors' profits and the promoter's activities." I believe that

> the third prong of the *Howey* test can be met by pre-purchase managerial activities of a promoter when it is the success of these activities, either entirely or predominantly, that determines whether profits are eventually realized. These pre-purchase activities must be directed at the sale of the investment opportunity; for example, efforts to build up a business are directed at making a business successful and therefore would not qualify, even if the ultimate aim is to sell the business to an investor. [citations omitted]. In practice, this requirement may impose a time element, as activities that do not occur around the time of sale are unlikely to be found to be directed at the sale of an investment opportunity. But provided the promoter's activities are so directed, the fact that the activities occurred prior to purchase would not bar the investment from qualifying as an investment contract under *Howey*.

Id. at 551 (Wald, J., dissenting).

248. For example, if an investor gives funds to Life Partners, and then Life Partners takes a few days to locate a viator, evaluate his or her medical condition, and pools that investor's funds with the funds of other investors, the investment is a security. However, if the same viator is located and evaluated just *before* the investor commits the money, that otherwise identical investment is not a security for purposes of the Securities Act. *See* Petition of the SEC for Rehearing and Suggestion for Rehearing *En Banc* at 6, SEC v. Life Partners, Inc., 898 F. Supp. 14 (D.D.C. 1995) (Nos. 95-5364, 96-5018 & 96-5090).

distinction that is without a difference in terms of the investors' needs for information, a central goal of the Securities Laws. Classifying viatical settlements as securities, while generating some additional expenses to promoters,[249] will increase the information flow and arguably bring additional investors into this market, while furthering the goals of the Securities Laws.[250] The D.C. Circuit's decision leaves investors in viatical settlements with the choice of making an investment decision based only on such information as they can gather on their own,[251] or simply walking away from the investment opportunities.[252]

No court before *Life Partners* has ever read into this prong of *Howey* a requirement that the efforts of others generating the profits be expended after the purchase of the investment, nor should they have.[253] Nonetheless, the D.C. Circuit did just that, creating a bright-line test, with no explicit precedential sup-

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In both situations investors rely on the promoter, and are in need of information about its expertise, its track record, its officers, and other matters, so that they may make an informed decision on whether to invest. The majority's test, as Judge Wald stated, "elevates a formal element, timing, over the economic reality of the investors' dependence on the promoter." *Id.* (citing *Life Partners*, 87 F.3d at 551).

249. These expenses could be passed on to the investors, as beneficiaries of the registration requirements.

250. "The depth, liquidity, and competitiveness of the market in viatical settlements. . . should be enhanced, not diminished, by requiring those who securitize viatical settlements to comply with the securities laws." Plaintiff's Reply Brief in Support of Motion for Preliminary Injunction and Other Provisional Relief and in Opposition to Defendants' Motion to Dismiss at 20, SEC v. Life Partners, Inc., 898 F. Supp. 14 (D.D.C. 1995) (No. 1: 94CV01861) (emphasis omitted).

251. Investors receive virtually no information regarding LPI, the company with which they are entering into a contractual relationship and to which they are entrusting their money. Unless they undertake to investigate Pardo and the company, they have no way of knowing that. [Pardo has had "issues" with federal regulators in the past— *see supra* note 122 hereof for a discussion of these issues.] Nor do they have any way of assessing LPI's financial condition; not only is LPI closely held, but its majority owners are offshore companies whose owners cannot be readily identified. Pardo himself, who founded LPI, claims not to know who the owners are.

Plaintiff's Brief in Support of Motion for Preliminary Injunction and Other Provisional Relief at 13-14, SEC v. Life Partners, Inc., 898 F. Supp. 14 (D.D.C. 1995) (No. 1: 94CV01861).

252. Query what would happen to this vital industry if investors simply opted out. Viators would be left with fewer and fewer options in terms of accessing death benefits, which might ultimately cost them their lives.

253. *See Life Partners*, 87 F.3d at 553 (Wald, J., dissenting).

port,[254] that distinguished pre-purchase efforts from post-

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254. The D.C. Circuit supports its decision to create this arbitrary and insupportable new bright-line test with two cases, both of which are factually distinguishable, and arguably do not support the new bright-line test. Neither case argues that the timing of the efforts of others is dispositive. Instead, the cases focus on "the role that market forces as opposed to the promoter's activities play in the realization of profits." *Id.*

First, in *Noa v. Key Futures, Inc.*, 638 F.2d 77 (9th Cir. 1980), the promoters offered investments in silver bars, which, unlike life insurance policies covering the lives of unique individuals, are fungible and capable of being independently and empirically evaluated. *See id.* at 79 Like Life Partners, Key Futures, the promoter, made efforts to locate prospective investors. However, unlike Key Futures, Life Partners performed "highly specialized functions in identifying and evaluating individual policies suitable for purchase by investors." *Life Partners*, 87 F.3d at 547.

Key Futures promised that, at a customer's request, it would store the silver bars at no charge for a year after purchase; further it promised to repurchase them at the spot price quoted in the *Wall Street Journal*. *See Noa,* 638 F.2d at 79. The *Noa* court concluded that these services were "only minimally related to the profitability of the investment: Once the purchase of silver bars was made, the profits to the investor depended upon the fluctuations of the silver market, not the managerial efforts of Key Futures." *Id.* at 79. This is the sum total of the *Noa* court's discussion of the managerial efforts requirement of the *Howey* test.

The *Noa* court found that, as a result, the investment contracts for the silver bars were not securities. *See id.* at 79-80. Despite the holding, the *Noa* court in no way articulated, even implicitly, a bright-line test splitting this prong of *Howey* into irrelevant pre-purchase efforts and dispositive post-purchase efforts. *See id.*

There is a significant difference between a commodity with an established market, whose value can be independently verified, and a commodity like the life insurance policy of a terminally-ill person. There is corresponding difference in the need for information about these two investments. As the *Life Partners* dissent points out:

> When profits depend on the intervention of market forces, there will be public information available to the investor by which the investor could assess the likelihood of the investment's success. . . . Where profits depend on the success of the promoter's activities, however, there is less access to protective information and the type of information that is needed is more specific to the promoter.

Life Partners, 87 F.3d 536, 552 (D.C. Cir. 1996) (Wald, J., dissenting).

Terminally ill policyholders are not fungible bars of silver. They are genetically different, living, breathing people, with widely disparate responses to even the same nominal medical condition. Information about them, and about the viatical settlement companies that promote investments in their life insurance policies, is thus highly individualized and not generally publicly available, in the absence of required disclosure of the relevant risk factors.

Life Partners claims that its investors play a very active role in the pre-purchase phase by setting up their own "purchase criteria" and reviewing the insured's health profile and policy. Nonetheless, the experts at Life Partners presumably prepared these same health profiles. The investors are asked for input like the amount they would like to spend, and to specify parameters like the ages purchase efforts, arbitrarily deciding that only post-purchase efforts were to be considered towards satisfaction of this prong.[255]

and T cell counts, but this investor input is of little practical significance. *See id.* at 547. However, as the district court said "[t]he mere retention of theoretical rights of control are of no consequence where the investor's role is essentially a passive one." *Life Partners*, 898 F. Supp. 14, 22 (D.D.C. 1995).

The second case relied on by the D.C. Circuit, *McCowan v. Heidler*, 527 F.2d 204 (10th Cir. 1975), involved promoters selling investments in undeveloped land, coupled with the promise to make future improvements on the plots. *See id.* at 205. The *McCowan* plaintiffs claimed these parcels were securities. *See id.* at 207. The court focused on the promoters' substantial pre-purchase efforts, and the promises to make post-purchase improvements; thus it found there was a factual question as to whether the sale of lots constituted the sale of securities and thus remanded the matter. *See id.* at 210. It is noteworthy that the *McCowan* court never articulated, even implicitly, that the pre-purchase efforts were irrelevant, or that the post-purchase efforts alone could satisfy *Howey*; arguably, the *McCowan* court looked at the combination of significant pre- and post-purchase efforts in the aggregate as satisfying this prong of *Howey*.

255. The D.C. Circuit did not agree that the time of sale is an artificial dividing line.

> If the investor's profits depend thereafter predominantly upon the promoter's efforts, then the investor may benefit from the disclosure and other requirements of the federal securities laws. But if the value of the promoter's efforts has already been impounded into the promoter's fees or into the purchase price of the investment, and if neither the promoter nor anyone else is expected to make further efforts that will affect the outcome of the investment, then the need for federal securities regulation is greatly diminished. While, to be sure, coverage under the 1933 Act might increase the quantity (and perhaps the quality) of information available to the investor prior to closing, 'the securities laws [are not] a broad federal remedy for all fraud.' [citations omitted]. They are concerned only with securities fraud, and the question before us is the threshold question whether a fractional interest in a viatical settlement is a security. To answer that question we look for 'an investment in a common venture' with profits 'derived from the entrepreneurial or managerial efforts of others.' [citations omitted].

SEC v. Life Partners, Inc., 87 F.3d 536, 547-48 (D.C. Cir. 1996).

However, as the SEC points out, in response:

> [t]hat first 'if,' however, rests on an assumption that runs counter to the essence of the securities laws. Pre-purchase efforts will only be 'impounded' into a securities price if the promoter has made full and fair disclosure of its efforts to the market. But if the forthrightness and honesty of promoters could simply be assumed, there would be no need at all for the securities laws. As Judge Wald observed 'the claim that investors need not be protected prior to committing funds has been rejected by Congress, which made the goal of ensuring that investors have adequate information before they commit their money. . . the central concern of the Securities Act.'

Petition of the SEC for Rehearing and Suggestion for Rehearing *En Banc* at 7, SEC v. Life Partners, Inc., 898 F. Supp. 14 (D.D.C. 1995) (Nos. 95-5364, 96-5018 & 96-5090).

The D.C. Circuit, in crafting this bright-line rule, lost sight of the letter of the law, as well as the spirit of the law.[256] The court gained a streamlined process for eliminating investments from the protection of the Securities Laws, but at a great cost.[257] The D.C. Circuit ignored the goals of the Securities Laws to provide investors with adequate and accurate information from which to make their decision. The court, in focusing almost exclusively on the life of the insured, left the investor to twist in the wind.[258]

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256. As the dissent says:

> Given the paucity of cases where pre-purchase managerial activities of the promoter alone are likely to create a security, my fear that the majority's approach will unduly restrict the flexibility of the *Howey* test might appear exaggerated. On the other hand, the difficulty with illustrating the restrictive effects of the majority's bright-line approach could be seen as a very good reason to preserve flexibility, for flexibility is what allows us to adapt our existing securities laws to address 'novel schemes,' schemes that we cannot easily anticipate ahead of time.

Life Partners, 87 F.3d at 554-55 (Wald, J., dissenting).

The SEC agreed:

> That artificial bright-line distinction between pre- and post-purchase efforts is antithetical to the aims of the securities laws. It deprives investors of the disclosure and other protections of those laws in situations where, precisely because the investors are relying on the promoters' efforts, expertise and fidelity, such protection is needed. This new rule places in question the applicability of the federal securities laws to other kinds of investments, such as certain asset-backed securities, that heretofore have long been recognized as securities.

Petition of the SEC for Rehearing and Suggestion for Rehearing *En Banc* at 1, SEC v. Life Partners, Inc., 898 F. Supp. 14 (D.D.C. 1995) (Nos. 95-5364, 96-5018 & 96-5090).

257. The advantage of this approach is that it offers a clear method for distinguishing between investment contracts that are securities and investment contracts that are simply investments. In that regard, it accords with the principle that the securities laws cannot be so broadly interpreted as to encompass all investments. But it does so at a substantial cost. Like the district court's approach, it elevates a formal element, timing, over the economic reality of the investors' dependence on the promoter. Even more troubling, the majority's approach undercuts the flexibility and ability to adapt to 'the countless and variable schemes' that are the hallmarks of the *Howey* test.

Life Partners, 87 F.3d at 551 (Wald, J., dissenting).

258. "In this case it is the length of the insured's life that is of overwhelming importance to the value of the viatical settlements marketed by LPI. As a result, the SEC is unable to show that the promoter's efforts have a predominant influence upon investors' profits; and because all three elements of the *Howey* test must

To honor the letter and the spirit of the *Howey* test, courts should look closely at the specifics of both the promoter's efforts and the particular investment. The district court did just that, concluding that it was free to look at promoter efforts before and after the sale of the investments.[259] In an investment such as a viatical settlement, some nominally pre-purchase efforts, like the negotiation of the purchase price for the policy, will continue to resonate long after the purchase of the investment essentially by determining the realization of profits. Therefore, such efforts should not be considered merely to affect the pre-purchase period.

The better choice for the D.C. Circuit would have been to read *Howey* the way the dissent advocated,[260] focusing on the degree of dependence between the investor's profits and the promoter, not solely on the timing of the promoter's efforts.[261] Pre-purchase efforts of the promoter would then completely satisfy the *Howey* test when the "realization of investors' profits depends predominantly on these activities."[262] This approach is in keeping with the economic reality of viatical settlements, and established case law. Instead, the D.C. Circuit left us with a new bright-line test, threatening to blind courts to the possibil-

be satisfied before an investment is characterized as a security, we must conclude that the viatical settlements marketed by LPI are not securities." *Id.* at 548.

259. According to the district court, "[a]s a general rule, the Court considers only managerial or entrepreneurial efforts which take place concurrently with or after the sale of the security. The Court remains free to consider the promoter's efforts immediately surrounding the sale when such efforts are based on the promoter's expertise." SEC v. Life Partners, Inc., 898 F. Supp. 14, 21 (D.D.C. 1995). "It would be improper in this era of increasingly complex investment tools for the Court not to consider the particular efforts of the promoter simply because the efforts occurred in the immediate context of the sale and not later." *Id.*

260. Judge Wald argued that *Howey's* third prong is satisfied "by pre-purchase managerial activities of a promoter when the eventual realization of profits depends predominantly on these activities and not on the market." *Life Partners*, 87 F.3d at 554 (Wald, J., dissenting).

261. The dissent undertakes this focus believing it to be more in keeping with the Supreme Court's decision in *Howey*, with its emphasis on substance over form, and because it furthers the idea that investors are protected by access to information. *See Life Partners*, 87 F.3d at 552 (Wald, J., dissenting).

262. *Id.* at 554 (Wald, J., dissenting). Courts often look at pre-purchase activities and post-purchase activities in satisfaction of the third prong of *Howey*. *See id.* at 553 (Wald, J., dissenting). For example, the dissent cites SEC v. Brigadoon Scotch Distribs., Ltd., 388 F. Supp. 1288 (S.D.N.Y. 1975), in which the court specifically stated that the pre-purchase activities there were enough to alone satisfy the third prong of *Howey*. *See Life Partners*, 87 F.3d at 553. (Wald, J., dissenting).

ity of loopholes to be exploited by crafty promoters seeking to avoid compliance with the Securities Laws by simply through manipulating the timing of their activities,[263] and threatening to undercut the courts' ability to rein in unscrupulous promoters.[264]

The D.C. Court's artificial bright-line test will only prove more artificial over time. With the advent of new drug therapies, like protease inhibitors, viatical settlements now arguably require additional "essential" post-purchase efforts. Taking or failing to take the drugs could bring the viator in as a possible "other" from whose efforts profits must derive. These new developments may make it even harder to accurately predict the life expectancy of AIDS patients, making the pricing of new policies purchased even more critical, and further affecting the re-

263. "It would make little sense to draw a sharp line between those efforts occurring at or around the time of the investment of money, and those occurring thereafter. Such a distinction would merely open a loophole whereby promoters would structure their operations so that efforts would occur prior to the final commitment of money by investors. The fundamental question is whether investors are dependent on the efforts of others, not when those efforts occur." Brief of the SEC, Appellee at 41; SEC v. Life Partners, Inc., 898 F. Supp. 14 (D.D.C. 1995) (Nos. 95-5364, 96-5018 & 96-5090).

264. According to the SEC:

> This rigid rule also threatens to give unscrupulous promoters a means of evading the securities laws by artificially deferring the "purchase" of the instruments they offer without changing their economic substance. Such an outcome runs counter to the Supreme Court's observation that because Congress "recognized the virtually limitless scope of human ingenuity" to devise "countless and variable schemes" to use other persons' money, it "enacted a definition of 'security' sufficiently broad to encompass virtually any instrument that might be sold as an investment."

Petition of the SEC for Rehearing and Suggestion for Rehearing *En Banc* at 3-4, SEC v. Life Partners, Inc., 898 F. Supp. 14 (D.D.C. 1995) (Nos. 95-5364, 96-5018 & 96-5090).

SEC Enforcement Director William McLucas called the D.C. Circuit's decision "troublesome," noting that the court's bright-line test could "potentially open the door. . .for a lot of imaginative schemes that people can put together" for which the SEC and Congress would have trouble "figuring out how to write rules or how to divine laws." John F. X. Peloso and Stuart M. Sarnoff, *Viatical Settlements: Another Form of Unregulated Investment*, N.Y.L. J., Aug. 15, 1996, at 3.

As the dissent points out, this new bright-line rule will apply to all investments, not just viatical settlements. So, for example, with derivative products, which, like viatical settlements, do not appear to satisfy the new bright line test, "the majority's approach could seriously hamper regulators as they seek to determine how best to treat this burgeoning class of financial instruments." SEC v. Life Partners, Inc., 87 F.3d 536, 557 (D.C. Cir. 1996) (Wald, J., dissenting).

turn to investors on existing policies, possibly requiring additional post-purchase efforts, such as repricing of viatical settlements.

This decision will have a great impact on viatical settlement firms, viators, investors, the SEC, and the courts.[265] Unless and until the D.C. Circuit's bright-line test is eliminated, or at least dimmed, viatical settlement firms can operate in the gaping hole of logic created thereby.[266] Viatical settlement firms should all retain counsel to ensure that they undertake no efforts after the closing. The cost of such counsel should be easily amortized over the increasing numbers of viators seeking viatication when suffering from AIDS and a host of other terminal illnesses.[267] However, investors will continue to suffer from a lack of material information. As viatical settlement firms revel in their Life Partners-induced euphoria,[268] investors may begin to move out of this unregulated industry, into other investments where disclosure is mandated, or at least where the specter of fraud is not looming quite so large. This will negatively impact viators. Without investors for these policies, these vulnerable, terminally-ill people may be unable to pay for life-sustaining treatments.

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265. The SEC has characterized the decision as having a "far-reaching negative impact on the Commission, investors and capital markets because it imposes unprecedented limits on the definition of the term 'security' under the federal securities laws." Petition of the Securities and Exchange Commission For Rehearing and Suggestion for Rehearing *En Banc* at 1, SEC v. Life Partners, Inc., 898 F. Supp. 14 (D.D.C. 1995) (Nos. 95-5364, 96-5018 & 96-5090).

266. According to the president of VAA, the *Life Partners* decision "affirms that there is a legal way to sell pieces of settlements to individuals without running afoul of SEC investment law." *See* Amy S. Friedman, *SEC Fines Florida Viatical Company*, NAT'L UNDERWRITER, May 18, 1998, at 21.

267. *See supra* note 33.

268. According to Mr. Pardo:

> This is clearly a victory for the terminally-ill, for small individual investors and for private enterprise, and for taxpayers and consumers. For four years the SEC has blatantly attempted to expand its regulatory authority, and has unwittingly abetted those interests determined to institutionalize the living benefits industry at the expense of the ill and the small investors. It has also given currency to those parties that would over-regulate the industry, inhibiting competition in a fair and open market, while depriving the needy ill of desperately needed funds and confidentiality.

U.S. Court of Appeals Foils SEC Bid to Regulate Viaticals, BUS.WIRE, Jan. 2, 1997, at 21.

Additionally, the SEC, and ironically, the federal court system itself, have all lost a valuable tool in the ongoing effort to adhere to the spirit and goals of the Securities Laws,[269] because they have lost the ability to retain oversight, through disclosure obligations, over perpetrators of the "countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."[270]

IV: The Continuing Efforts to Protect Investors in Viatical Settlements

In December 1996, the court denied the SEC's petition for rehearing in the Life Partners litigation.[271] The SEC ultimately declined to appeal the decision to the United States Supreme Court. Accordingly, the D.C. Circuit's bright-line test remains the law, leaving investors in viatical settlements vulnerable to dishonest and unscrupulous promoters, without the protection of the Securities Laws. However, the SEC has not given up the fight to regulate what it terms "ongoing violations of the registration and antifraud provisions" of the Securities Laws.[272] Until the Supreme Court takes up this issue and snuffs out the D.C. Circuit's bright-light test, the SEC has simply changed strategies in its efforts to protect investors in viatical settlements. Although the D.C. Circuit's bright-line test is not binding outside of its jurisdiction,[273] the decision reverberates through the states, as some state securities departments have

269. "Throughout the history of struggling for an appropriate definition, courts have been mindful of the fact that the bottom-line question is whether the particular investment or instrument involved is one that needs or demands the investor protection of the federal (or state) securities laws." Hazan, *supra* note 150 at 30-31.

270. SEC v. W.J. Howey Co., 328 U.S.293, 299 (1946).

271. *See* SEC v. Life Partners, Inc., 102 F.3d 587 (D.C. Cir. 1996); the SEC then filed an unsuccessful Motion Seeking Leave to Amend Complaint; SEC v. Life Partners, Inc., 986 F. Supp. 644 (D.D.C. 1997).

272. *See* Plaintiff's Brief in Support of Motion for Preliminary Injunction and Other Provisional Relief at 1; SEC v. Life Partners, Inc., 898 F. Supp. 14 (D.D.C. 1995) (No. 1: 94CV01861); *see also* Vickers, *supra* note 39, at 3.

273. To date, the bright-line test set out in the D.C. Circuit's opinion in *Life Partners* has not been relied on.

looked to *Life Partners* as they position viatical settlements within their own securities law frameworks.[274]

Much of the current battle to regulate fractional interests in viatical settlements as securities is now being waged at the state level. Viatical settlements have attracted regulatory scrutiny in Alabama,[275] Arizona,[276] California,[277] Colorado,[278] Con-

274. For example, the State of Connecticut, although not bound by the *Life Partners* decision, nonetheless took the decision into account in answering a request for a No-Action letter on viatical settlements.

> In light of [the *Life Partners* decision], and the reasoning contained within that decision, this department will take no enforcement action at this time if viatical settlements are sold absent securities registration under the Act. . .Be advised that this department is taking this position based upon the current state of the law in this rapidly developing area; should the jurisprudence in this field be reversed, this department reserves the right to regulate viatical settlements under the Act in the future.

State of Connecticut Office of the Banking Commissioner, 1996 Conn. Sec. No-Act. LEXIS 32, at *1-2 (Sept. 18, 1996).

275. The Alabama Securities Commission obtained a Cease and Desist Order against a viatical settlement firm, on the grounds that, among other matters, the "Policy Purchase Agreements" offered by the respondents constituted securities as defined in ALA. CODE § 8-6-2(10) (1975). *See In re* Life Options Int'l, Inc., No. CD-98-0027; 1998 Ala. Sec. LEXIS 25, at *1 (Apr. 15, 1998).

276. Arizona now regulates viatical settlements at both the legislative and administrative levels. The state enacted a statute classifying viatical settlements as securities under its state securities law. *See* ARIZ. REV. STAT. § 44-1801(23) (1998). The director of the Arizona Corporation Commission's Securities Division said the state was seeking to govern unregistered representatives who sell viatical settlements, in an effort to curb the increasing fraud in the viatical settlement industry. *See Arizona May Be First to Define Death Benefit as a Security*, COMPLIANCE REP., Mar. 2, 1998.

On the administrative front, the Arizona Corporation Commission obtained a Cease and Desist Order against a business trust that sold subscriptions and pooled the funds to invest in viatical settlements, on grounds that, among other matters, the investments in the interests sold were securities within the meaning of ARIZ. REV. STAT. § 44-1801(23) (1998). *See In re* Offering of Securities by: Federal Funding Foundation Corporation, Docket Nos. S-3175-I, S-3180-I; Decision No. 60926; 1998 Ariz. Sec. LEXIS 24, at *1 (May 26, 1998).

277. California has a viatical statute that covers the traditional viator protection areas, like minimum payments, disclosure and licensing. The statute also requires viatical settlement firms to provide disclosure to investors that are comparable to those required under the Securities Act. *See* CAL. INS. CODE § 10113.2 (1997); *see also* Davis *supra* note 216, at 85; *supra* note 98.

278. The Colorado Division of Securities has taken the position in "No Action" letter that viatical settlements constitute "investment contracts" and thus "securities," as defined in the Colorado Securities Act at section 11-51-201(17), C.R.S. (1997). *See Re*: Cotton Ranch Metropolitan District General Obligation Bonds Series 1998A - $2,000,000, 1998 Colo. Sec. No-Act. LEXIS 1 (Mar. 26, 1998).

necticut,[279] Florida,[280] Idaho,[281] Kansas,[282] Massachusetts,[283]

According to the Division, although the SEC did not prevail in *Life Partners*, that decision "was based on the particular fact pattern involved in that case. The manner in which other federal district and circuit courts dealing with federal securities laws as well as state courts interpreting state securities laws may react to the same or similar fact patterns remains an open question." Re: Viatical Settlement Contracts under the Colorado Securities Act, [No number in original] State of Colorado Department of Regulatory Agencies Division of Securities, 1997 Colo. Sec. No-Act. LEXIS 10, at *3 (June 2, 1997).

The Division went on to say that they were not banning, and indeed could not ban, viatical settlements. However, the Division felt it would be prudent for "investment professional doing business in Colorado and elsewhere to refrain from offering or selling — not just investments involving viatical settlement contracts but — any unregistered, non-exempt "exotic" investment product without more definite and express regulatory and judicial authority to the effect that they are not securities. Anyone who ignores this general maxim does so at their peril." *Id.* at *4.

279. *See supra* note 274.

280. According to the Office of the Comptroller in Florida, the "sale by a terminally ill person of the right to death benefit proceeds from his or her life insurance policy does not in itself violate Florida law. Sale of the right to those proceeds by the original purchaser to yet another party may very well constitute violations of FL law if the right to the proceeds is combined or packaged or divided into shares." *See Florida Office of the Comptroller, Viatical Settlements - Humanitarian Investments with Great Risk of Fraud*, PR NEWSWIRE, Apr. 16, 1996.

281. *See supra* note 109.

282. The Kansas securities commissioner recently warned four viatical settlement companies to revise some potentially misleading statements in their presentations to potential investors in Kansas. *See* Gene Meyer, *Mixing Death and Profit: Viatical Contracts Bring Cash to the Terminally Ill, Profit to Investors*, KANSAS CITY STAR, May 10, 1998, at F1.

Further, the Office of Securities Commissioner of the State of Kansas issued a No-Action letter in November 1995 that essentially tracks the *Life Partners* facts. The Commissioner applied the *Howey* test, and found that the first and third prongs were indisputably met. He paused on the second prong, the common enterprise requirement, but found that "[t]o the extent that the viatical settlement pools the funds from multiple investors to purchase the benefits of a single policy, horizontal commonality, which is universally accepted as satisfying this element of the test, is clearly present." The Commissioner ultimately was of the opinion that viatical settlements are securities, which he finds to be consistent with the district court opinion in *Life Partners*; this no-action letter was issued between the district court decision and the D.C. Circuit decision in *Life Partners*. *See Re*: Interpretive Opinion - Viatical Settlements Definition of a Security – KAN. STAT. ANN. § 17-1252(j), 1995 Kan. Sec. No-Act. LEXIS 188, (Nov. 14, 1995).

283. *See supra* note 99 and accompanying text.

Michigan,[284] Missouri,[285] North Dakota,[286] Washington,[287] Wisconsin,[288] and Wyoming.[289]

Viatical Settlements as Securities After *Life Partners*: the *Mutual Benefits* Case

The SEC is continuing its efforts to regulate fractional interests in viatical settlements. The agency received welcomed news in a U.S. District Court case it filed against one of the

284. *See* GREGORY A. POPOWICZ, MICHIGAN DEPT. OF COMMERCE CORPORATION & SECURITIES BUREAU, RE: POPOWICZ – VIATICAL CONTRACT SETTLEMENTS, 1 ("It is the Bureau's position that the fractionalized interests (pooling arrangements) are securities as defined in Section 401(1) of the Act").

285. The Missouri Securities Commission has repeatedly found viatical settlements to be securities as defined under Section 409.401, RSMo Cumulative Supp. 1997. *See In re* Masters Group Mktg., Inc., File No. CD-98-54, 1998 Mo. Sec. LEXIS 51 (Sept. 18, 1998); *see also In re* Capwill & Company, Order No. CD-98-26, Missouri Securities Commission, 1998 Mo. Sec. LEXIS 29 (May 21, 1998); *In re* Alpha & Omega Asset Protection Strategies, LLC, Order No. CD-98-28, Missouri Securities Commission 1998 Mo. Sec. LEXIS 6 (May 15, 1998); *In re* Aide the Living Inc. et al, Order No. CD-98-25, Missouri Securities Commission, 1998 Mo. Sec. LEXIS 30 (Mar. 23, 1998).

286. *See In re* Raoul Brandt, 1996 N. Dak. Sec. LEXIS 6 (Nov. 15, 1996).

287. The Washington Securities Division looked to the trial court opinion in *Life Partners* and an interpretive opinion from the Missouri Office of the Secretary of State discussing viatical settlements; the Division concluded that

> [t]o the extent that the viatical settlement programs [offered] contain features similar to those discussed in the LPI cases and the Missouri interpretative opinion, it is likely that those programs involve the offer and sale of securities pursuant to RCW 21.20.005(12). We also note that in interpreting any viatical settlement program, the Division will be guided by the principle that 'securities regulation is remedial in nature and has as its purpose broad protection of the public. Thus it is appropriate to construe the statute broadly in order to maximize the protection offered.'

File No. O-01646, 1996 Wa. Sec. LEXIS 27 (Mar. 29, 1996); *see also* [No number in original], 1996 Wa. Sec. LEXIS 19 (June 4, 1996); File No. O-01997, 1996 Wa. Sec. LEXIS 21 (July 14, 1997).

288. *See supra* note 109; *see also In re* Viatical Capital Inc., File No. S-9711(EX), Wisc. Sec. Commission; 1998 Wisc. Sec. LEXIS 190 (Feb. 19, 1998).

289. The Wyoming Secretary of State, Securities Division has examined the viatical question, and has not yet taken a formal position on whether viatical settlements constitute securities. The Division looks at each viatical settlement on a case-by-case basis. *See* WYOMING SECRETARY OF STATE; SECURITIES DIVISION, RE: VIATICAL SETTLEMENT CONTRACTS 1 (May 21, 1996). "The Wyoming Securities Division views viatical settlements as investment contracts securities and will enforce W.S. § 17-4-107 requiring registration of securities prior to their sale and W.S. § 7-4-103 requiring those who sell securities to be licensed and subject to investor protection rules." WYOMING SECRETARY OF STATE; SECURITIES DIVISION (Apr. 26, 1996).

nation's largest viatical settlement firms, Mutual Benefits Corp., of Fort Lauderdale, Florida ("MBC").[290] As in the Life Partners litigation, the SEC alleged that the viatical settlement firm sold $100 million in unregistered viatical settlements to 1,190 investors from October 1994 until April 1996. This time, however, the viatical settlement firm agreed to a settlement, giving the SEC its first win in its effort to regulate fractional interests in viatical settlements.[291]

In the settlement, the two principals involved in MBC neither admitted nor denied the allegations; but they each agreed to pay $50,000 in fines and a total of $850,000 in restitution.[292] Both agreed to be permanently enjoined from violating registration and antifraud provisions of the federal securities laws.[293]

The MBC scam was much like the viatical settlement frauds on investors discussed in Part III. MBC offered its investors "guaranteed" fixed returns of 12 to 42 percent, depending on the life expectancy of the insured.[294] The firm's promotional materials claimed viatical settlements were "a fully secured, non-speculative financial opportunity."[295] MBC ghoulishly played up AIDS as a deadly disease, and soft-pedaled the ability of modern medicine to offer life-prolonging or curative treatments.[296]

MBC made numerous misrepresentations, such as telling investors that their funds would be kept in a special trust account.[297] The money was actually held in MBC's operating account.[298] Further, MBC failed to disclose to investors that funds would typically be held for several weeks before a policy was

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290. *Brothers Pay $950,000 to Settle SEC Charges*, DALLAS MORNING NEWS, May 2, 1998, at 2F [hereinafter *Brothers*].

291. *See* Friedman, *supra* note 266, at 21; *see also Brothers*, *supra* note 290, at 2F.

292. *See Brothers*, *supra* note 290, at 2F; *see also* Humberto Cruz, *Viatical Deals Trigger Fines; Pompano Men to Pay Interest on Investment*, SUN-SENTINEL, May 2, 1998, at 15C.

293. *See* Cruz, *supra* note 292, at 15C.

294. *Id.*

295. Allen, *supra* note 24, at W13.

296. *See id.*

297. *See* Cruz, *supra* note 292, at 15C.

298. *See* Helen Huntley, *SEC Wins Battle Over Viatical Settlements*, ST. PETERSBURG TIMES, May 2, 1998, at 8E.

found. This delay effectively lowered the return on the investment.[299] The MBC principals also misrepresented that they had experience in the viatical settlement industry and that they held "irrevocable interests" in some policies, which are not permitted on life insurance policies of veterans and members of the armed services.[300] The SEC argued that the principals knew "full well" that the law prohibited them from putting an irrevocable interest on these policies.[301]

According to the SEC, the firm was "pooling investments, and then selling them for actualized interests, which under current law, is what a security is."[302] This is exactly what the SEC argued in *Life Partners*, and despite the disappointing ruling in that case, the SEC vows to press on.[303] While the MBC settlement does not set a legal precedent for the SEC, it sets a practical precedent, as it represents the first time the agency has obtained a fine and injunctive relief against a viatical settlement company.[304] Furthermore, the MBC case has received much attention from other interested parties besides the SEC, as viatical settlement industry trade groups are closely following the SEC's progress.[305]

Conclusion

Despite the insupportable holding in *Life Partners*, investors in viatical settlements must be provided adequate information to allow them to evaluate their investment opportunity. This is the overriding goal of the Securities Laws — that issuers (and other participants in the sale of securities, like underwrit-

299. *See* Cruz, *supra* note 292, at 15C; *see also Viatical Firm Pays $950,000 to Settle SEC Complaint*, BESTWIRE, May 5, 1998, at 219 [hereinafter *Firm Pays*].

300. *See* Cruz, *supra* note 292, at 15C.

301. *See Firm Pays*, *supra* note 299, at 219 (quoting Christian Bartholomew, SEC senior trial counsel in Miami).

302. *See* Friedman, *supra* note 266, at 21 (quoting Christian Bartholomew, senior trial lawyer for the SEC in Miami).

303. According to Mr. Bartholomew, the MBC case "says pretty clearly that under appropriate facts and circumstances we will continue to pursue viatical settlement cases." *See* Huntley, *supra* note 298, at 8E; *see also Brothers*, *supra* note 290, at 2F.

304. *See* Friedman, *supra* note 266, at 21.

305. According to the president of VAA, "[k]nowing when such a sale becomes a security sale is 'very high on our radar screens this year." Friedman, *supra* note 266, at 21.

ers and control persons) would therefore be prohibited from making materially misleading statements or omissions. This prohibition was designed to alleviate the fear that a lack of adequate information would lead to pricing that did not reflect the true value of the investment.

The method for accomplishing this goal is already in place; the registration requirements of the Securities Laws and the resulting continuous disclosure obligations thereunder would insure that investors are provided with both the information needed to make investment decisions and the statutory remedies to redress any failure thereof.

Requiring sellers of fractional interests in viatical settlements to register such sales and to participate in the continuous disclosure system is expensive and time consuming, but it would be more expensive, in a broader sense, to permit these securities to be unregistered, both for viatical investors and for the integrity of the securities market in general. If the resales of these fractional interests in viatical settlements are not classified as securities for purposes of the Securities Laws, the continuous disclosure system would not be triggered, and information asymmetries would threaten the continued presence of investors in the industry. This, coupled with the specter of fraud, could well spell the end of what should be a financially sound and socially beneficial industry.