
YALE LAW & POLICY REVIEW

Viatical and Life Settlement Securitization: Risks and Proposed Regulation

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* Yale Law School, J.D. expected June 2011; Stanford University, B.A. 2006. I would like to thank George Priest, Yair Listokin, Jay Bhattacharya, Noah Messing, Julia Lisztwan, Fran Faircloth, Adam Yoffie, my parents, and U.W. for their invaluable support.

INTRODUCTION

A new industry grew out of the AIDS crisis of the 1980s: the secondary trade in life insurance policies.¹ Victims of HIV and AIDS faced certain death—half within the first year after diagnosis, and eighty-five percent within three years.² Meanwhile, AIDS rendered its victims both physically debilitated³ and socially untouchable,⁴ often cutting them off from employment⁵ and employer-provided health insurance.⁶ Treatment, though largely ineffective,⁷ cost the average patient up to \$80,000.⁸ Those infected—at first, predominantly gay men⁹—were often abandoned by their families,¹⁰ and government programs provided little support.¹¹

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1. Francis Flaherty, *Death Benefits Become Living Benefits*, N.Y. TIMES, Oct. 16, 1993, § 1 (Magazine), at 37 (discussing viatical settlement as a mechanism to finance medical treatment and other living expenses).
 2. MIRKO D. GRMEK, *HISTORY OF AIDS: EMERGENCE AND ORIGIN OF A MODERN PANDEMIC* 94 (Russell C. Maulitz & Jacalyn Duffin trans., Princeton Univ. Press 1990) (1989).
 3. JONATHAN ENGEL, *THE EPIDEMIC: A GLOBAL HISTORY OF AIDS* 30 (2006) (“[E]nd-stage AIDS entailed a wholesale dissolution of the patient’s immune system . . .”).
 4. TAMSIN WILTON, *ANTIBODY POLITIC: AIDS AND SOCIETY* 20 (1992) (“[P]eople living with HIV and with AIDS have become social outcasts in a way which is reminiscent of the treatment meted out to people with leprosy or bubonic plague in the Middle Ages. . . . [T]hey and their families and associates have been subject to neglect, ostracism, abuse and even violence.”).
 5. Edward H. Yelin et al., *The Impact of HIV-Related Illness on Employment*, 81 AM. J. PUB. HEALTH 79, 79 (1991).
 6. Nancy E. Kass et al., *Loss of Private Health Insurance Among Homosexual Men with AIDS*, 28 INQUIRY 249, 249-253 (1991).
 7. GRMEK, *supra* note 2, at 183-87.
 8. David E. Bloom & Geoffrey Carliner, *The Economic Impact of AIDS in the United States*, 239 SCIENCE 604, 605-06 (1988); see also SUSAN HUNTER, *AIDS IN AMERICA* 179-80 (2006) (discussing a patient’s \$35,000-per-year treatment costs); Fred J. Hellinger, *Forecasting the Medical Care Costs of the HIV Epidemic: 1991-1994*, 28 INQUIRY 213, 217 (1991) (estimating costs for non-AIDS HIV patients at \$5,150 per year and for AIDS sufferers at \$32,000 per year). See generally Lee Ann Dean, Note, *Acquired Immune Deficiency Syndrome, Viatical Settlement, and the Health Care Crisis: AIDS Patients Reach into the Future To Make Ends Meet*, 25 RUTGERS L.J. 117, 122-27 (1993) (discussing increases in AIDS treatment costs).
 9. B. Frank Polk, *The Epidemiology of the HTLV-III Virus (April 3, 1986)*, in *AIDS AND EMPLOYMENT: FACTS AND MYTHS, A SPECIAL REPORT OF THE PROCEEDINGS OF A SEMINAR HELD AT THE ANNUAL MEETING OF THE PRESIDENT’S COMMITTEE*

In desperate need, AIDS sufferers accepted offers from investors to buy their tragically valuable life insurance policies.¹² Sellers received cash on which to subsist; buyers gained an investment with a virtually certain, near-term payout. These transactions were called viatical settlements—named for the Viaticum, the Eucharist given in the Roman Catholic Church as last rites to the dying.¹³

The viatical settlements market crashed in the mid-1990s when protease inhibitors suddenly and radically extended life expectancies of persons with AIDS, substantially delaying payouts for investors.¹⁴ The industry shifted its focus to other groups of terminally ill policyholders¹⁵ and, ultimately, to elderly insureds. Unlike diseases vulnerable to dramatic advances in medical technology, old age provides investors with a relatively stable and predictable basis on which to make purchase decisions.¹⁶ Today, viatical settlements represent a small portion of the secondary market in life insurance policies, the bulk of which consists of “life settlements” with elderly policyholders.¹⁷

ON EMPLOYMENT OF THE HANDICAPPED, 1986, at 18, 27 (discussing findings that 73% of the first 15,000 reported infections afflicted gay or bisexual men).

10. See Kay B. Tiblier et al., *Therapeutic Issues When Working with Families of Persons with AIDS*, in *AIDS AND FAMILIES* 81 (Eleanor D. Macklin ed., 1989) (discussing the impact of factors such as ethnicity, religion, and socioeconomic class on acceptance and rejection of AIDS victims by family members).
11. JAMES MONROE SMITH, *AIDS AND SOCIETY* 151-52 (1996).
12. Flaherty, *supra* note 1, at 37.
13. OXFORD ENGLISH DICTIONARY 589 (2d ed. 1989); see also *Siporin v. Carrington*, 23 P.3d 92, 93 n.1 (Ariz. Ct. App. 2001) (“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 last rites—something to sustain the deceased person on his or her ‘last journey.’” (citing *THE AMERICAN HERITAGE DICTIONARY OF THE AMERICAN LANGUAGE* 1988 (3d ed. 1996))).
14. David W. Dunlap, *AIDS Drugs Alter an Industry’s Math; Recalculating Death-Benefit Deals*, N.Y. TIMES, July 30, 1996, at D1 (discussing how protease inhibitors reduced viatical settlement profitability and forced providers to seek customer groups suffering from illnesses other than AIDS); see also Frank J. Palella et al., *Declining Morbidity and Mortality Among Patients with Advanced Human Immunodeficiency Virus Infection*, 338 NEW ENG. J. MED. 853 (1998) (attributing decreased morbidity of AIDS patients to anti-retroviral medications).
15. Dunlap, *supra* note 14, at D1.
16. Ellen Kelleher, *Cash in on the American Way of Death*, FIN. TIMES, Oct. 12, 2007, <http://www.ft.com/cms/s/2/13b09204-78b3-11dc-aa2-0000779fd2ac.html>.
17. *Recent Innovations in Securitization: Hearing Before the Subcomm. on Capital Mkts., Ins., and Gov’t Sponsored Enters. of the H. Comm. on Fin. Servs.*, 111th Cong. 46 n.4 (2009) [hereinafter *Securitization Hearings*] (statement of J. Russel Dorsett,

To date, each settlement has generally stood as an investment unto itself, but Wall Street has shown new interest in the prospect of securitizing life settlements¹⁸—that is, pooling large numbers of policies and issuing multiple levels or tranches of bonds backed by the pool. Wall Street's interest, however, comes in the wake of the mortgage securitization crisis and the Great Recession,¹⁹ naturally raising concerns that life settlement securitization could lead to similar problems.²⁰

According to the financial scholarship, the causes of the mortgage securitization crisis were a number of risk-expanding “frictions”—mostly information asymmetries and interest misalignments.²¹ As a result of these frictions, no market participant had sufficient information and incentive to minimize risk. Borrowers did not fully understand complex mortgage agreements and had strong incentives to access quick cash through borrowing. Many also erroneously assumed that rising home values would enable them to refinance. Banks had incentives to lend to non-credit-worthy borrowers because loans could be sold to securitization arrangers, shielding lenders from any risk of default. Likewise, arrangers were able to pass risk on to investors through bond sales. Investors—or more typically, investment managers—relied on the bonds' attractive credit ratings, which were based on the strong historical performance of mortgages and failed to account adequately for correlation risk (the risk that many defaults would occur at once).²² When property values did fall, refinancing became difficult, and defaults became prevalent. Investors suffered tremendous losses, the market for resale of loans evaporated, and lending stopped.²³

President, Life Insurance Settlement Association); Rebecca Knight, *A Safer Way of Dicing with Death*, FIN. TIMES (London), Mar. 5, 2005, at m24.

18. Matt Brady, *The Presence of Institutional Investors Grows*, NAT'L UNDERWRITER LIFE & HEALTH INS. NEWS (Nov. 11, 2007), available at <http://www.lifeandhealthinsurancenews.com/Issues/2007/42/Life%20Settlement%20Supplement/Pages/The-Presence-Of-Institutional-Investors-Grows.aspx>.
19. For an overview of the start of the Great Recession and its effects on Wall Street, see COUNCIL OF ECON. ADVISERS, ANNUAL REPORT 41-44 (2010), available at http://fraser.stlouisfed.org/publications/erp/issue/1694/download/17625/ERP_AR_CEA_2001.pdf.
20. For simplicity, I use “life settlement securitization” to include both viatical and life settlements.
21. Adam B. Ashcraft & Til Schuermann, *Understanding the Securitization of Subprime Mortgage Credit* (Wharton Fin. Insts. Ctr., Working Paper No. 07-43, 2008), available at <http://ssrn.com/abstract=1071189>. I adopt Ashcraft and Schuermann's terminology because I build on their analysis, but the term “friction” may incorrectly suggest that these sources of risk increase tension and conflict. They might be better characterized as “over-lubrication” because they encourage execution of risky transactions.
22. *Id.* (manuscript at ii).
23. See COUNCIL OF ECON. ADVISERS, *supra* note 19, at 41-44.

Law provided no significant *ex ante* incentives for market participants to exercise care in securitizations. Courts have largely interpreted current law as leaving losses with investors,²⁴ and the Securities Exchange Commission's (SEC) only major suit brought in response to the crisis addressed the special case of the allegedly *intentional* creation of faulty investments by Goldman Sachs.²⁵ As such, Congress began deliberating how to overhaul U.S. financial regulations to prevent similar crises in the future.²⁶

In September 2009, a *New York Times* article described how Wall Street securitizers were turning their attention away from the ashes of the mortgage market and towards life settlements. The article warned against hasty investment in a market that could prove as disaster-prone as that for mortgage-backed securities (MBS).²⁷ When Congress held hearings on the issue three weeks later, representatives of the life settlement industry roundly dismissed fears that securitization in their market could lead to trouble.²⁸ The industry's claims were backed by arguments that death rates, unlike default rates, do not fluctuate significantly with economic cycles.²⁹ Congress has since remained si-

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24. See, e.g., *Teamsters Local 445 Freight Div. Pension Fund v. Dynex Capital, Inc.*, 531 F.3d 190 (2d Cir. 2008) (dismissing a securities fraud claim because alleged financial mismanagement lacked scienter).
25. Complaint, *SEC v. Goldman Sachs & Co.*, No. 10-CV-3229 (S.D.N.Y. Apr. 16, 2010).
26. See discussion *infra* Part III.
27. Jenny Anderson, *New Exotic Investments Emerging on Wall Street*, N.Y. TIMES, Sept. 6, 2009, at A1.
28. See *Securitization Hearings*, *supra* note 17 (statement of Brian D. Pardo, Chairman and Chief Executive Officer, Life Partners Holdings, Inc.); see also *id.* (statement of Daniel Curry, President, DBRS, Inc.); *id.* (statement of J. Russel Dorsett, President, Life Insurance Settlement Association); *id.* (statement of Jack Kelly, Director of Government Affairs, Institutional Life Markets Association); *id.* (statement of Steven H. Strongin, Managing Director, Global Investment Research, Goldman, Sachs & Co.).
29. See Patrick D. Dolan, *Securitization of Life Settlements, Structured Settlements and Lottery Awards*, in *NEW DEVELOPMENTS IN SECURITIZATION 2008*, at 957, 961 (PLI Commercial Law & Practice Course Handbook Series No. 14108, 2008) (noting that the life settlement-backed security "has attracted attention because it is a 'non-correlative' asset"); Matthew Goldstein, *Profiting from Mortality: Death Bonds May Be the Most Macabre Investment Scheme Ever Devised by Wall Street*, BUS. WK. (July 30, 2007), available at http://www.businessweek.com/magazine/content/07_31/b4044001.htm (describing life settlements as "uncorrelated assets"). Death rates do correlate to economic growth, but negatively; a deep recession would increase death rates and, if anything, speed life settlement payouts. Harvey Brenner, *Commentary: Economic Growth Is the Basis of Mortality Rate Decline in the 20th Century—Experience of the United States 1901-2000*, 34 INT'L J. EPIDEMIOLOGY 1214 (2005).

lent on the issue, and the industry has continued its development in the absence of regulation.

This Note takes up the question Congress began to ask: could viatical and life settlement securitization create substantial risks to investors and the economy?³⁰ Is new regulation necessary to prevent future problems? I conclude that life settlement securitization does exhibit, sometimes in nuanced forms, many of the weaknesses and risks seen in mortgage securitization. I argue that under the wrong conditions, a securitized life settlement market could collapse in the same fashion as the market for mortgage-backed securities. Furthermore, preventing such a collapse calls for tailored regulation.

Steven Strongin, Goldman Sachs's Head of Global Investment Research, argued in congressional testimony that "life settlement securitizations do not appear to pose any special securitization related risk and can be treated like any other securitization."³¹ He is wrong. But so far, Congress has followed Strongin's advice and largely ignored non-loan types of securitization, such as life settlement collateralization. As Chairman of the Senate Banking Committee, Senator Chris Dodd claimed that recently enacted financial reform "doesn't just look through the rear-view mirror to address the failures that caused the economic crisis. It looks through the windshield" to prevent the next set of problems.³² However, a close reading of the new law shows that its language does not address many of the risks in life settlement securitization. The securitization debate in legal scholarship has scrutinized the causes of the late crisis,³³ ruminated on other markets that could fall prey to securitization's weaknesses,³⁴ and discussed ways to reform.³⁵ However, like Congress, legal academia has overlooked

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30. Some readers may question why society should allow securitization in this market or even countenance the secondary market at all. However, the virtues of viatical and life settlements—providing value to the sick and elderly who may have few other assets—are significant, and securitization generally serves to increase societal wealth and clarify investment risk. See Neil Doherty & Hal Singer, *The Benefits of a Secondary Market for Life Insurance Policies*, 38 REAL PROP. PROB. & TR. J. 449 (2003); Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133 (1994).
31. *Securitization Hearings*, *supra* note 17, at 96 (statement of Steven H. Strongin, Managing Director, Gloval Investment Research, Goldman, Sachs & Co.).
32. Chris Dodd, *We Won't Get Caught off Guard Next Time*, HARTFORD COURANT, April 25, 2010, http://articles.courant.com/2010-04-25/news/hc-dodd-truth-about-finance-ref.artapr25_1_wall-street-firms-bill-curbs.
33. See, e.g., Steven L. Schwarcz, *Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown*, 93 MINN. L. REV. 373 (2008).
34. See, e.g., Kenneth C. Kettering, *Securitization and Its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1553 (2008).
35. See, e.g., Thomas E. Plank, *Sense and Sensibility in Securitization: A Prudent Legal Structure and a Fanciful Critique*, 30 CARDOZO L. REV. 617 (2008); Steven L. Schwarcz, *The Future of Securitization*, 41 CONN. L. REV. 1313 (2009).

life settlement collateralization and the potential effects of new financial regulation on non-loan types of securitization.

It should be noted that while a life settlement securitization crisis could be structurally similar to the mortgage crisis, the life settlement market is projected to reach \$160 billion in face value by 2030³⁶—a modest size compared to the \$19.1 trillion in life insurance in force at the end of 2008,³⁷ or the \$14.4 trillion in outstanding mortgage debt at the close of 2009.³⁸ Nevertheless, even a relatively minor life settlement crisis could cost billions of dollars. A less likely worst-case scenario in the life settlement market could rival the magnitude of major historic economic crises. For example, the Savings and Loan Crisis led to direct costs of \$146 billion, spread over the 1980s and 1990s.³⁹ More recently, the Asian Financial Crisis centered on asset devaluations that cost investors \$80 to \$100 billion in the second half of 1997.⁴⁰

The primary concern in a life settlement meltdown would be that an initial loss of value in the ballpark of those that caused these historic crises—even if smaller after accounting for inflation and economic expansion—would give rise

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36. SUNEET KAMATH & TIMOTHY SLEDGE, SANFORD C. BERNSTEIN & CO., LIFE INSURANCE LONG VIEW—LIFE SETTLEMENTS NEED NOT BE UNSETTLING 8 (2005), available at <http://www.coventry.com/pdfs/Bernstein.pdf>. A similar number is cited in *Life Partners, Inc. v. Morrison*, 484 F.3d 284, 288 (4th Cir. 2007).
37. AM. COUNCIL OF LIFE INSURERS, LIFE INSURERS FACT BOOK 2009, at 66 tbl.7.1 (2009), available at <http://www.acli.com/NR/rdonlyres/oBFEABCA-1E2A-4F4C-A879-95CF104238AB/22615/2009LifeInsurersFactBook1.pdf>.
38. *Mortgage Debt Outstanding*, BD. OF GOVERNORS OF THE FED. RESERVE SYS. (Dec. 2009), <http://www.federalreserve.gov/econresdata/releases/mortoutstand/mortoutstand20091231.htm>.
39. Timothy Curry & Lynn Shibut, *The Cost of the Savings and Loan Crisis: Truth and Consequences*, 13 F.D.I.C. BANKING REV. 26, 31 tbl.4 (2000). For a discussion of how overly generous commercial lending brought about this crisis, see JAMES R. BARTH, *THE GREAT SAVINGS AND LOAN DEBACLE* (1991).
40. M. Faizul Islam, *The Asian Five: From Financial Crisis to Economic Recovery*, in ASIAN FINANCIAL CRISIS 123, 123 (J. Jay Choi ed., 2000). In that crisis, “[f]oreign borrowing led to a domestic lending boom across all of Asia, which generated multiple asset bubbles, especially in stock markets and real estate. . . . There was simply too much foreign money chasing too few sound investments. . . .” Karl D. Jackson, *Introduction: The Roots of the Crisis*, in ASIAN CONTAGION: THE CAUSES AND CONSEQUENCES OF A FINANCIAL CRISIS 1, 5 (Karl D. Jackson ed., 1999). Asset bubbles burst when foreign investors pulled funds out of Asia, causing major exchange rate changes, which were initially perceived as the source of the crisis. *Id.* at 3. For deeper analysis of the sources of the Asian crisis, see Giancarlo Corsetti et al., *The Asian Crisis: An Overview of the Empirical Evidence and Policy Debate*, in THE ASIAN FINANCIAL CRISIS: CAUSES, CONTAGION, AND CONSEQUENCES 127, 141 (Pierre-Richard Agénor et al. eds., 1999), which finds that the Asian crisis’s turmoil correlated to weaknesses in the Asian economy such as the prevalence of non-performing loans.

to a market panic, perhaps greatly out of proportion to actual flaws in market fundamentals.⁴¹ Whether an economic crisis develops depends on how the relevant assets are concentrated in the economy and how clearly the market understands the relevant risks.⁴² For example, in the mortgage crisis, institutions that had little exposure to bad assets nonetheless suffered an exodus of investment dollars because “investors could not penetrate the portfolios far enough” to determine the true level of risk.⁴³ It is more than conceivable that, as in the mortgage crisis, major financial institutions would be among the investors most hurt by a collapse of life settlement securitization. Moreover, if a crisis freezes this market, mark-to-market rules—which require balance sheets to reflect the present value of financial assets—could force investment houses to treat settlement-backed securities as worthless and report them immediately as losses.⁴⁴ As financial institutions increase their reserves to safeguard against such losses, they necessarily lend less to others, causing further contraction in the financial sector.⁴⁵

Troubles like those seen at Bear Stearns and Lehman Brothers could raise concerns about counter-party risk—fears that loans to troubled institutions would ultimately go unpaid—and hence a freezing up of credit markets.⁴⁶ As with MBS, the complexity and lack of clarity surrounding life settlement securitization could easily cloud other actors’ understanding of the true risks and spread panic in the financial sector. So, while the life settlement market will not rival the systemic threat to the economy posed by the mortgage collapse, it still has the potential to cause a significant crisis in the U.S. and global economies. Such a meltdown is worth preventing. This Note seeks to show how.

Analysis here proceeds in three parts. Part I provides background on the viatical and life settlement industry and recent movements towards securitization. Part II makes an original contribution to scholarship in this area by inspecting life settlement securitization for the risk-expanding frictions that others have identified as roots of the mortgage securitization crisis. Part II also identifies three frictions unique to life settlement securitization and suggests how these frictions, especially in combination, might lead to market disorder. Part III reviews current regulatory proposals for securitization and calls for ad-

41. See Gary Gorton, *The Panic of 2007* (Yale Int’l Ctr. for Fin., Working Paper No. 08-24, 2008), available at <http://ssrn.com/abstract=1255362>.

42. *Id.*

43. *Id.* (manuscript at 59).

44. *Statement of Financial Accounting Standards No. 157: Fair Value Measurements*, FIN. ACCT. SERIES, Sept. 2006.

45. See Ben S. Bernanke, *Non-Monetary Effects of the Financial Crisis in the Propagation of the Great Depression*, 73 AM. ECON. REV. 257 (1983).

46. See Frederic S. Mishkin, *Asymmetric Information and Financial Crises: A Historical Perspective*, in FINANCIAL MARKETS AND FINANCIAL CRISES 69, 71 (R. Glenn Hubbard ed., 1991).

ditional regulations to resolve the unique and subtle frictions of life settlement securitization.

I. DEVELOPMENT OF THE VIATICAL AND LIFE SETTLEMENTS MARKET

This Part describes (A) the emergence of the settlements market; (B) the rise of stranger-oriented life insurance as a means of circumventing insurable interest laws; (C) regulation of the evolving industry; (D) recent market trends and movements toward securitization of life settlements; and (E) the reaction to the settlement securitization that has begun to occur.

A. Emergence of the Settlements Market

The secondary market for life insurance—the market into which insureds can sell their own policies—has existed in some form for over a century. As early as 1855, New York’s Court of Appeals recognized the right of an insured to sell his policy to a third party.⁴⁷ The U.S. Supreme Court followed in 1911 with *Grigsby v. Russell*, finding in favor of secondary policy sales as a matter of pre-*Erie* federal common law and declaring, “The law has no universal cynic fear of the temptation opened by a pecuniary benefit accruing upon a death.”⁴⁸

Few policyholders, however, exercised their right to sell, and no robust secondary market developed.⁴⁹ Instead, throughout most of the twentieth century, insureds typically surrendered their policies back to their insurers for a fraction of face value when they could no longer afford their premiums or no longer needed insurance. As the only practical and interested purchasers, insurance firms enjoyed significant monopsony power in repurchasing the policies they had issued. Surrender prices remained low until the advent of viatical settlements.⁵⁰

In 1988, amidst the perfect storm of the AIDS crisis, viatical settlement providers began buying HIV patients’ life insurance policies,⁵¹ examining policyholders’ medical records, setting prices based on life expectancies, and paying

47. *St. John v. Am. Mut. Life Ins. Co.*, 13 N.Y. 31, 39 (1855) (“It seems to me it cannot be doubted, but that the assured might legally assign the policies to the plaintiff.”).

48. 222 U.S. 149, 155-56 (1911) (holding valid a life insurance policy sale to a third party lacking an insurable interest).

49. See Doherty & Singer, *supra* note 30, at 451 n.5.

50. *Id.* at 450; see also Neil A. Doherty et al., *The Secondary Market for Life Insurance Policies: Uncovering Life Insurance’s “Hidden” Value*, 6 MARQ. ELDER’S ADVISOR 95, 101-03 (2005) (“In its early stages, this market consisted of only the issuing life insurance carrier and a handful of individual speculators at the margins.”).

51. Flaherty, *supra* note 1, at 37.

premiums for the duration of settled policies.⁵² Payouts to policyholders, or “viators,” ranged from below 50% of face value for those expected to live up to twenty-four months, to 80% for those expected to die within six months.⁵³

Insurers stood to lose from the advent of viatical settlements. Without a secondary market, more insureds would have failed to pay premiums, allowing term policies to lapse or surrendering universal or whole life policies for a small payout.⁵⁴ An insurer’s financial planning depends on accurately forecasting these lapse rates: since an insurer does not pay death benefits on a lapsed policy, the insurer can charge lower premiums, making its policies more competitive in the primary market. Reduced lapse rates mean increased costs for insurance providers and hence, higher premiums for insureds.⁵⁵

In response to competition from viatical settlements, many insurers instituted “accelerated death benefits” in the 1990s—in essence, higher surrender values for insureds with reduced life expectancies.⁵⁶ In this competition, though, insurers enjoyed the advantage of legitimacy. The viatical industry had struggled from its inception to establish a respectable image in spite of its inherently morbid trade—and its entanglement with fraud and crime.

At different times, fraud has infected every stage of the viatication and life settlement process. Viators have hidden illnesses from insurers (sometimes with accomplices to stand in at physical examinations),⁵⁷ and healthy policyholders have conspired with physicians to fake serious illnesses, inflating settlement proceeds.⁵⁸ New York Attorney General Eliot Spitzer sued a settlement provider

52. *Id.*

53. Joseph B. Treaster, *Death Benefits, Now for the Living*, N.Y. TIMES, Sept. 27, 1998, § 3, at 1.

54. See Doherty & Singer, *supra* note 30, at 450-51.

55. See Terry M. Magady, *Practice Tips: Selling Life Insurance on the Secondary Market*, 28 L.A. LAW. 14 (2006). Empirically, the lapse rate for all U.S. life insurance policies fell from 8.9% in 1988 to 5.8% in 1998, though this drop may reflect causes other than viatical and life settlement proliferation. AM. COUNCIL OF LIFE INS., LIFE INSURANCE FACT BOOK 11 (1999); see also Laurence Mauer & Neil Holden, *Determinants of the Lapse Rate in Life Insurance Operating Companies*, 28 REV. BUSINESS 54 (2007).

56. Doherty & Singer, *supra* note 30, at 466-67. Like a monopsonist, “a monopolist loses its price-setting ability with the entry of competition.” *Id.* (citing WILLIAM J. BAUMOL & ALAN S. BLINDER, *ECONOMICS: PRINCIPLES AND POLICY* 272 (6th ed. 1994)).

57. *Retirement Protection: Fighting Fraud in the Sale of Death: Hearing Before the Subcomm. on Oversight and Investigations of the H. Comm. on Fin. Servs.*, 107th Cong. 2-3 (2002) (statement of Lee Covington, Director, Ohio Department of Insurance).

58. Knight, *supra* note 17.

for allegedly paying brokers to ignore other providers' bids⁵⁹ (the suit ultimately settled out of court).⁶⁰ Others have defrauded investors by exaggerating expected profits or embezzling entrusted funds.⁶¹ Additional cases demonstrate the potential for murder. For example, two septegenarian women in California befriended two homeless men, bought life insurance on them, and then killed them. The women collected \$2.8 million in death benefits before being convicted for murder and sentenced to life in prison.⁶² Meanwhile, federal authorities sought forfeiture of \$4 million in benefits paid upon the death of a Florida man whose policy was purchased by a Colombian drug cartel as part of a money-laundering scheme.⁶³ While murder has not been alleged in this case, the dangers in such situations are clear.

B. *Stranger-Oriented Life Insurance*

Perhaps the most important fraud for the insurance settlement industry comes in the form of "stranger-oriented life insurance" or "STOLI"⁶⁴—a transaction in which a third-party investor typically pays an upfront amount to an individual insured under a new policy for which the investor pays premiums, usually through a nonrecourse loan secured by the policy. At the end of the contestability period typically imposed by insurers, the insured has the option to allow the investor to foreclose on the policy or to keep the policy by repaying the loan plus a (usually high) rate of interest.⁶⁵ The latter option may be attrac-

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59. Complaint, *New York v. Coventry First LLC*, No. 404620-06 (N.Y. Sup. Ct. Oct. 26, 2006); Charles Duhigg & Joseph B. Treaster, *Spitzer Suit Accuses Company of Abuses in Insurance for Elderly and Ill*, N.Y. TIMES, Oct. 27, 2006, at C3.
60. Trevor Thomas, *Coventry Settles N.Y. Case*, NAT'L UNDERWRITER LIFE & HEALTH INS. NEWS, Oct. 1, 2009, available at <http://www.lifeandhealthinsurancenews.com/News/2009/10/Pages/Coventry-Settles-NY-Case.aspx>.
61. See, e.g., Goldstein, *supra* note 29; Susan McRae, *Victims Get Another Chance To Win Back Swindled Funds*, DAILY J. (L.A.), Sept. 25, 2002, at 1 (noting a settlement provider executive's guilty plea to defrauding investors out of over \$95 million); Press Release, Fed. Bureau of Investigation, U.S. Dep't of Justice, *Westlake Village Man Who Orchestrated \$64 Million Ponzi Scheme Sentenced to 25 Years in Federal Prison* (Nov. 3, 2009), available at <http://losangeles.fbi.gov/dojpressrel/pressrel09/la110309.htm>.
62. *Life Terms in 'Black Widow' Case*, WASH. POST, July 16, 2008, at A3.
63. *Complaint for Forfeiture in rem*, *United States v. Four Million Dollars*, No. 05-CV-61399 (S.D. Fla. 2005).
64. Though STOLI remains technically legal in some jurisdictions, I discuss it mainly as a form of fraud on insurers because most jurisdictions regard it as such.
65. J. Alan Jensen & Stephan R. Leimberg, *Stranger-Owned Life Insurance: A Point/Counterpoint Discussion*, 33 ACTEC J. 110, 111 (2007).

tive to an insured whose health has worsened and who wants to retain the policy to benefit family members or to sell to other investors.⁶⁶

Though some argue that STOLI is not inherently problematic,⁶⁷ the prevailing view holds the practice in disfavor.⁶⁸ STOLI may sound purely beneficial to potential insureds, who choose never to pay toward the policy, but a number of hidden costs can arise. For example, after transferring the policy to investors, an elderly individual may be unable to obtain other insurance because insurers will count the transferred insurance against the individual's limited insurability.⁶⁹ Moreover, any benefits to the insured—including upfront gifts or forgiveness of indebtedness at transfer—constitute income on which the insured must pay taxes.⁷⁰

Most important from a public policy perspective, STOLI is a method of circumventing insurable interest laws.⁷¹ These laws render void all life insurance contracts issued without an insurable interest, defined, for example, in New York as:

(A) in the case of persons closely related by blood or by law, a substantial interest engendered by love and affection;

(B) in the case of other persons, a lawful and substantial economic interest in the continued life, health or bodily safety of the person insured, as distinguished from an interest which would arise only by, or would be enhanced in value by, the death, disablement or injury of the insured.⁷²

66. *Id.* at 111.

67. *Id.* at 110.

68. See generally Eryn Mathews, Note, *STOLI on the Rocks: Why States Should Eliminate the Abusive Practice of Stranger-Owned Life Insurance*, 14 CONN. INS. L.J. 521 (2008) (discussing STOLI's risks to consumers, insurers, and investors).

69. Jensen & Leimberg, *supra* note 65, at 115-16.

70. I.R.C. § 61(a)(12) (2006); Jensen & Leimberg, *supra* note 65, at 116.

71. Mathews, *supra* note 68, at 527-28.

72. N.Y. INS. LAW § 3205(a)(1) (Consol. 2007). For other jurisdictions' insurable interest laws, see, for example, CAL. INS. CODE § 10110.1 (Deering 2007); D.C. CODE § 31-4716 (2007); FLA. STAT. § 627.404 (2009); VA. CODE ANN. § 38.2-301 (2007). Illinois requires insurable interest as a matter of common law. *Guardian Mut. Life Ins. Co. v. Hogan*, 80 Ill. 35, 39 (1875). Anglo-American insurable interest laws date back to Britain's Life Assurance Act 1774, still in effect, which provides: "Whereas . . . the making insurances on lives . . . wherein the assured shall have no interest, hath introduced a mischievous kind of gaming: . . . no insurance shall be made by any person . . . on the life . . . of any person . . . wherein the person . . . for whose . . . benefit . . . such policy . . . shall be made, shall have no interest . . ." Act of 1774, 14 Geo. 3, c. 48, § 1 (Eng.).

Insurable interest laws have two purposes: prevention of gambling on the lives of others, and avoidance of incentives for murder.⁷³ When first recognizing a right to policy resale, the U.S. Supreme Court also condemned what would now be called STOLI: “cases in which a person having an interest lends himself to one without any, as a cloak to what is, in its inception, a wager, have no similarity to those where an honest contract is sold in good faith.”⁷⁴ The Southern District of New York reiterated the sentiment in 2008:

Only one who obtains a life insurance policy on himself “on his own initiative” and in good faith—that is, with a genuine intent to obtain insurance protection for a family member, loved one, or business partner, rather than an intent to disguise what would otherwise be a gambling transaction by a stranger on his life—may freely assign the policy to one who does not have an insurable interest in him.⁷⁵

Many states have interpreted their insurable interest laws to prohibit STOLI transactions,⁷⁶ and many insurers have added questions to their application forms aimed at discovering whether an application has been instigated by a third party.⁷⁷ Other states have outlawed STOLI, as discussed below, through their broader regulation of viatical and life settlements.

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73. See, e.g., Ben Kingree & Louise Tanner, *Life Insurance as Motive for Murder*, 29 TORT & INS. L.J. 761, 764 text accompanying nn.61-64 (1994) (discussing anti-wagering and anti-murder rationales for insurable interest laws as well as insurers’ liability for “unreasonably imperil[ing] the lives of their insureds”). But see Jacob Loshin, Note, *Insurance Law’s Hapless Busybody: A Case Against the Insurable Interest Requirement*, 117 YALE L.J. 474 (2007) (arguing that insurable interest laws create moral hazard by relieving insurers of the need to ferret out uninsurability).
74. *Grigsby v. Russell*, 222 U.S. 149, 156 (1911).
75. *Life Prod. Clearing LLC v. Angel*, 530 F. Supp. 2d 646, 653 (S.D.N.Y. 2008). But see *Sun Life Assurance Co. of Can. v. Paulson*, No. 07-3877, 2008 WL 451054, at *1 (D. Minn. Feb. 15, 2008) (dismissing insurer’s claim for failing to allege that any buyer prompted insured to purchase policy).
76. See Op. Off. Gen. Counsel (N.Y. Jun. 3, 2003) (regarding New York’s insurable interest law, N.Y. INS. LAW § 3205 (McKinney Supp. 2003): “New York has a strong public policy against speculation on the death of individuals. Accordingly, one may not, with limited exceptions, take out a policy of life insurance on the life of another.”); IDAHO DEPT. OF INS., BULL. NO. 07-03, STRANGER OR INVESTOR OWNED LIFE INSURANCE ARRANGEMENTS (2007); LA. DEPT. OF INS., BULL. NO. 06-05, AUTHORIZED AND UNAUTHORIZED QUESTIONS FOR USE ON A LIFE INSURANCE APPLICATION (2006); UTAH DEPT. OF INS., BULL. NO. 2006-3, INSURABLE INTEREST AND LIFE INSURANCE (2006).
77. Kelly J. Bozanic, Comment, *An Investment To Die For: From Life Insurance to Death Bonds, the Evolution and Legality of the Life Settlement Industry*, 113 PENN ST. L. REV. 229, 246 n.128 (2008).

C. Regulation to Date

In the 1990s, states began adopting regulations to keep pace with changes in the secondary market for life insurance. The Fourth Circuit affirmed in 2007 that the McCarran-Ferguson Act protects such state regulations from dormant Commerce Clause preemption as state laws “relating” to or enacted “for the purpose of” regulation of insurance.⁷⁸ States have based much of their regulation on two model acts.⁷⁹ The first, published in 1993 by the National Association of Insurance Commissioners (NAIC), is the Viatical Settlement Model Act.⁸⁰ It requires settlement providers to make certain disclosures to viators⁸¹ and investors,⁸² to obtain a license to sell life insurance from the insurance commission of the viator’s state of residence;⁸³ and to obtain the commissioner’s approval for the settlement contract forms they use.⁸⁴ The Act also contains privacy protections, generally barring disclosure of a viator’s identity.⁸⁵ NAIC broadened its Model Act in 2000 to include settlements for viators who are not terminally ill, thus encompassing what the industry refers to as life settlements within the definition of viatical settlements.⁸⁶ In accompanying regulations, NAIC proposes minimum prices for settlements, based on percentages of a policy’s face value.⁸⁷

The second model law is the Life Settlements Model Act published by the National Conference of Insurance Legislators (NCOIL) in 2000, amended in

78. *Life Partners, Inc. v. Morrison*, 484 F.3d 284, 292-93 (4th Cir. 2007) (interpreting 15 U.S.C. §§ 1011-12 (2006)).

79. For fuller discussion of state regulation and the model acts, see generally Sachin Kohli, Comment, *Pricing Death: Analyzing the Secondary Market for Life Insurance Policies and Its Regulatory Environment*, 54 *BUFF. L. REV.* 279, 303-13 (2006) (addressing ways legislation can improve the secondary market for life insurance); Jessica Maria Perez, Note, *You Can Bet Your Life on It! Regulating Senior Settlements To Be a Financial Alternative for the Elderly*, 10 *ELDER L.J.* 425 (2002) (discussing how state statutes can protect the elderly from fraud, and can make life insurance settlements more feasible as investment options).

80. VIACICAL SETTLEMENTS MODEL ACT (Nat’l Assoc. of Ins. Comm’rs 1993).

81. VIACICAL SETTLEMENTS MODEL ACT § 8(A)-(D) (Nat’l Assoc. of Ins. Comm’rs 2008).

82. *Id.* § 8(E)-(F).

83. *Id.* § 3.

84. *Id.* § 5.

85. *Id.* § 6(B).

86. VIACICAL SETTLEMENTS MODEL ACT § 2(R) (Nat’l Assoc. of Ins. Comm’rs 2000).

87. VIACICAL SETTLEMENTS MODEL REGULATION § 5, Alternative I (Nat’l Assoc. of Ins. Comm’rs 2008). For discussion of how price floors function to prevent otherwise socially beneficial transactions, see Jay Battacharya et al., *Price Regulation in Secondary Insurance Markets*, 71 *J. RISK & INS.* 643, 660 (2004).

2004 and 2007.⁸⁸ Like the NAIC Act, NCOIL's proposed law includes disclosure,⁸⁹ privacy,⁹⁰ and licensing⁹¹ requirements, but does not put forward any pricing regulations. NCOIL's proposal also limits investor contact with the policy-seller to once every three months for those with life expectancies over one year, and once per month for those with life expectancies of one year or less.⁹²

Both the NAIC and NCOIL model acts have been updated to combat STOLI transactions. NAIC amendments adopted in 2007 generally mandate a five-year waiting period from policy issuance to sale, though broad exceptions allow earlier settlement in the case of retirement, divorce, loss of employment, or spouse's death. Settlements are allowed after two years for policies that are independently funded and for which there has been no agreement or evaluation for settlement.⁹³ The Life Insurance Settlement Association (LISA), an industry group, argues that the NAIC amendments are overbroad and threaten to block legitimate settlements.⁹⁴ LISA prefers the NCOIL model, which calls for only a two-year waiting period.⁹⁵

In all, forty-four states have enacted some regulation of life insurance settlements (though four regulate only settlements for the terminally or chronically ill, and one, Arizona, has only a STOLI prohibition).⁹⁶ Fraud in the life insurance settlement market has decreased since adoption of these regulations. LISA reports that NAIC's Complaints Database (generally available only to regulators) has registered only nine complaints since 2005,⁹⁷ and NAIC asserts that "most settlement frauds now involve the investor side of the transaction, not the insurance policyholder side."⁹⁸

88. LIFE SETTLEMENTS MODEL ACT (Nat'l Conf. of Ins. Legislators 2007), available at http://www.thevoiceoftheindustry.com/files/ncoil_2007_NCOIL_Life_Settlements_Model_Act_ADOPTED_11-16-07_CLEAN_COPY.pdf.

89. *Id.* § 9.

90. *Id.* § 6.

91. *Id.* § 3.

92. *Id.* § 9(A)(13).

93. VIATICAL SETTLEMENTS MODEL ACT, *supra* note 81, § 11(A).

94. See Bozanic, *supra* note 77, at n.118.

95. See LIFE SETTLEMENTS MODEL ACT, *supra* note 88, § 11(N); NCOIL Model Act, LIFE INSURANCE SETTLEMENT ASSOCIATION, <http://www.lisassociation.org/lifsettlementtruth/NCOIL.html> (last visited Oct. 23, 2010).

96. See *Regulation of Viatical and Life Settlements*, LIFE INSURANCE SETTLEMENT ASSOCIATION, (Nov. 1, 2010), http://www.lisassociation.org/vlsaamembers/legislative_maps/images/Reg-of-viatical-and-life-se.jpg.

97. *Securitization Hearings*, *supra* note 17, at 47 (statement of J. Russel Dorsett, President, Life Insurance Settlement Association).

98. Doherty & Singer, *supra* note 30, at 477 n.76.

Meanwhile, federal regulation of viatical and life settlements is in flux. The SEC has asserted: “[L]ife settlements are securities, and, therefore, are subject to the requirements of the federal securities laws, including the antifraud rules.”⁹⁹ The D.C. Circuit has disagreed, ruling in the 1996 case *SEC v. Life Partners* that life insurance settlements are not securities under current federal law.¹⁰⁰ Then-Judge Ruth Bader Ginsburg wrote for the Circuit that the settlements’ status as securities depends on the test laid out in *SEC v. W.J. Howey Co.*, which requires “(1) an expectation of profits arising from (2) a common enterprise that (3) depends upon the efforts of others.”¹⁰¹ The court held that the fractional interests of settlements in question met the first two prongs but not the third because the investors’ profits depended on the death of the policy-seller, not any post-sale entrepreneurial efforts of settlement arrangers.¹⁰²

In the 2007 decision *SEC v. Mutual Benefits*, the Eleventh Circuit rejected the rule adopted by the D.C. Circuit.¹⁰³ That court held that life insurance settlements are securities under *Howey*’s broad interpretation of the Securities Acts of 1933 and 1934, noting that the D.C. Circuit’s distinction between pre- and post-sale effort was novel and not envisioned by the holding in *Howey*.¹⁰⁴ Several states also interpret their own securities laws to cover settlement contracts.¹⁰⁵ This Note will focus on regulation applied directly to life settlement securitizations, but the foregoing state and federal regulations give an important indication of the regulatory standards and disclosure requirements that must be met by insurance settlements before they become part of any securitization.

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99. *Securitization Hearings*, *supra* note 17, at 59 (statement of Paula Dubberly, Associate Director, Division of Corporate Finance, United States Securities and Exchange Commission).
 100. *SEC v. Life Partners, Inc.*, 87 F.3d 536 (D.C. Cir. 1996).
 101. *Id.* at 542 (citing *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946)).
 102. *Id.* at 549.
 103. *SEC v. Mut. Benefits Corp.*, 408 F.3d 737 (11th Cir. 2005).
 104. *Id.* at 743-45; *see also* *Wuliger v. Eberle*, 414 F. Supp. 2d 814, 824 (N.D. Ohio 2006) (rejecting the *Life Partners* rule in adopting the broader *Howey* interpretation).
 105. *See, e.g.*, *Siporin v. Carrington*, 23 P.3d 92, 98 (Ariz. Ct. App. 2001) (“[T]he fact that [defendant’s] efforts preceded the sale of interests in viatical settlements to its investors does not change the nature of the investment.”); *Sec. Comm’r for Colo. v. Viatica Mgmt. LLC*, 55 P.3d 264 (Colo. App. 2002); *Sec. Trust Corp. v. Fisher*, 797 N.E.2d 789 (Ind. Ct. App. 2003) (same); *Poyser v. Flora*, 780 N.E.2d 1191, 1195 (Ind. Ct. App. 2003) (finding that a viatical settlement is an “investment contract” that meets the Indiana Code’s definition of “security”); *Michelson v. Voison*, 658 N.W.2d 188 (Mich. Ct. App. 2003) (deferring to state agency interpretation of Michigan securities laws that viatical settlements are securities).

D. Recent Market Trends and Moves Toward Securitization

This Section describes the current state of the insurance settlement market and its movements towards securitization. Though it is the focus of significant regulation, the current market for life insurance settlements is modest in size. Based on an estimated \$10 billion paid for settlements between 1999 and 2009, LISA judges that policy-sellers received \$6-7 billion more than they would have by surrendering their policies to insurers.¹⁰⁶ Meanwhile, Bernstein & Co. estimates that investors earn 9-13% on a settlement investment of average duration with death seven to eight years after sale.¹⁰⁷ Outside that range, investors' estimated profits are highly sensitive to seller life spans: 101% for death within two years, but dropping to 3% for death eleven years after sale.¹⁰⁸

Conning & Company estimates that at the end of 2007, there were roughly \$31 billion in outstanding settlements measured by policy face value,¹⁰⁹ but LISA estimates that by 2008, \$3-4 billion in capital was invested per year in viatical and life settlements worth \$12-15 billion in policy face value.¹¹⁰ However, the industry was hit hard by the credit crisis of 2008 and 2009. Investment in 2009 appears to have fallen by more than 50% from 2008 levels, due largely to a lack of available investment capital.¹¹¹ In 2010, Goldman Sachs abandoned the life settlement industry, though some attribute the move to a desire to avoid negative publicity from dealing in death benefits.¹¹²

Still, there is significant potential for growth in the life settlement industry. Strong expectations of future market growth are driven in large part by projected growth in the elderly population of the United States. According to Census Bureau analysis, the population of Americans over sixty-five will swell beyond seventy-two million by 2030 (from a current level just over forty mil-

106. Trevor Thomas, *Life Settlement Regulation Proliferated*, NAT'L UNDERWRITER LIFE & HEALTH INS. NEWS, Dec. 28, 2009, available at <http://www.lifeandhealthinsurancenews.com/Top-Ten-Stories-2009/Pages/Life-Settlement-Regulation-Proliferated.aspx>.

107. KAMATH & SLEDGE, *supra* note 36, at 5.

108. *Id.*

109. Jamie McGee, *Life Settlement 'Hit Hard' by Recession, Conning Says*, BLOOMBERG, Oct. 8, 2009, <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aAzY2pJtw1To>.

110. *Securitization Hearings*, *supra* note 17, at 9, 13 (statement of J. Russel Dorsett, President, Life Insurance Settlement Association).

111. *Id.*

112. Trevor Thomas, *Execs React to Goldman Shuttering Its Settlement Unit*, NAT'L UNDERWRITER LIFE & HEALTH INS. NEWS, Feb. 8, 2010, available at <http://www.lifeandhealthinsurancenews.com/Exclusives/2010/2/Pages/Feature-Execs-react-to-Goldman-shuttering-its-settlement-unit.aspx>.

lion).¹¹³ While (pre-Great Recession) studies indicate that roughly half of the Baby Boomers are preparing adequately to maintain their standards of living into retirement, many are not.¹¹⁴ Though non-savers tend to be poorer and, therefore, less likely to own life insurance,¹¹⁵ those who do have policies will still face increasing reason to sell. There are also reports of increasing availability of life settlements to insureds with low-face-value policies.¹¹⁶

Inspired by these prospects for growth, investors have begun contemplating the securitization of life settlements. Like other types of securitization, the process for securitizing life insurance policies entails pooling large numbers of payment obligations as collateral for an issuance of bonds, which are referred to as asset-backed securities (ABS) or collateralized debt obligations (CDO).¹¹⁷ Credit rating agencies (CRAs) rate the investment risk of these financial instruments—as they do other bonds—usually on letter-based scales where a greater number of *As* indicates lower risk. In order to win higher credit ratings (and therefore higher sales prices), securitizers generally transfer the assets they wish to securitize into a bankruptcy-remote trust (often referred to as a “special purpose vehicle” or “SPV”). This protects investors from the risk of securitizer insolvency because the assets underlying the investors’ bonds are then generally unavailable to pay off the securitizer’s debts. Courts will respect such bankruptcy remoteness, however, only if they find that there has been a “true sale” by the arranger to the SPV.¹¹⁸

Bonds are issued in levels or tranches, guaranteeing the first profits to holders of the senior-most tranche, ideally characterized by very low risk and a very

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113. U.S. CENSUS BUREAU, STATISTICAL ABSTRACT OF THE UNITED STATES: 2010, tbl.8, available at <http://www.census.gov/prod/2009pubs/10statab/pop.pdf>.
 114. CONG. BUDGET OFFICE, BABY BOOMERS’ RETIREMENT PROSPECTS: AN OVERVIEW 2 (2003), available at <http://www.cbo.gov/ftpdocs/48xx/doc4863/11-26-BabyBoomers.pdf>.
 115. John J. Burnett & Bruce A. Palmer, *Examining Life Insurance Ownership Through Demographic and Psychographic Characteristics*, 51 J. RISK & INS. 453 (1984).
 116. Linda KOCO, *Settlements of Small Face Policies Start To Emerge*, NAT’L UNDERWRITER LIFE & HEALTH INS. NEWS, Sept. 2, 2008, available at <http://www.lifeandhealthinsurancenews.com/Exclusives/2008/09/Pages/Feature-Settlements-of-small-face-policies-start-to-emerge.aspx>.
 117. See S.L. SCHWARCZ ET AL., *SECURITIZATION, STRUCTURED FINANCE AND CAPITAL MARKETS* § 1 (2004).
 118. *Id.* §§ 3.03(A)-(B). For a definition of “true sale,” see Steven L. Schwarcz, *The Parts Are Greater than the Whole: How Securitization of Divisible Interests Can Revolutionize Structured Finance and Open the Capital Markets to Middle Market Companies*, 1993 COLUM. BUS. L. REV. 139, 143 (1993) (“Sales that are effective against creditors and the estate of a bankrupt originator, in that the property is no longer ‘property of the debtor’s estate’ under Section 541 of the Bankruptcy Code, are generally referred to as ‘true sales.’” (footnote omitted)).

high credit rating.¹¹⁹ The theory of securitization relies in significant part on the law of large numbers: “if a pool is extremely diversified, with large numbers of obligors each liable for a small percentage of the dollar amount of the pool, one may more confidently rely on the statistical history of the pool.”¹²⁰

Securitization has been credited for much of the tremendous growth of the U.S. financial sector over recent decades but also blamed as a cause of the Great Recession.¹²¹ The *New York Times* article that sparked Congress’s interest in life settlement securitization commented on a similar duality: the potential for profit in a new financial product, coupled with the fear of a new market crisis.¹²² In fact, however, securitization has existed in the realm of insurance for some time but has been focused on assets and risks other than life settlements.¹²³ These are generally ways for insurers to spread risk. For example, in natural catastrophe bonds (“cat bonds”), insurers sell promises to pay high yields, except in the event of a natural disaster of designated magnitude. Since the insurer keeps funds in such a contingency, the insurer is effectively shielded from the risk of natural disasters that give rise to significant insurance claims.¹²⁴ Mortality cat bonds perform a similar function, but only if an event causes deaths beyond a specified threshold.¹²⁵ As such, recent fears of an H1N1 swine flu pandemic stirred interest in increased insurer-side securitization of life insurance through mortality cat bonds.¹²⁶

More traditionally, insurers have sought protection from excessive claims by purchasing reinsurance. Reinsurance providers also seek to smooth their risk profiles in the retrocessional market—essentially the market for reinsurance of reinsurance liabilities. Increasingly, reinsurance providers are also sharing their risks with capital markets through securitization.¹²⁷ In 2005, reinsurer Swiss Re

119. Schwarcz, *supra* note 30, at 136-37.

120. SCHWARCZ ET AL., *supra* note 117, § 1.03(A). For general information on the law of large numbers, see GEOFFREY R. GRIMMETT & DAVID R. STIRZAKER, *PROBABILITY AND RANDOM PROCESSES: PROBLEMS AND SOLUTIONS* (1993).

121. See, e.g., Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019 (2007).

122. See Anderson, *supra* note 27.

123. See Alex Cowley & J. David Cummins, *Securitization of Life Insurance Assets and Liabilities*, 72 J. RISK & INS. 193, 194 (2005).

124. A.M. BEST CO., *THE GUIDE TO UNDERSTANDING INSURANCE RATINGS* 16 (2009).

125. *Id.* at 17.

126. Colleen McCarthy, *Pandemic Fears May Trigger More Securitizations*, BUS. INS., Oct. 26, 2009, at 19, available at <http://www.businessinsurance.com/article/20091025/ISSUE03/310259994>.

127. Regis Coccia, *Retrocessional Market Options Ride on Securitization*, BUS. INS., Sept. 21, 2009, at 17, available at <http://www.businessinsurance.com/article/20090920/ISSUE03/309209992>.

issued bonds for \$245 million backed by a pool of life insurance policies the firm had reinsured.¹²⁸ Note that such securitization is a mirror image of life settlement securitization: instead of insureds selling their claims to death benefits that are then pooled, insurers sell their claims to premium streams that are then pooled and collateralized. As life settlement investors stand to profit by the early deaths of policy-sellers, investors in reinsurance recoverables profit from the greater longevity of insureds.

Unlike these insurer-side securitizations, however, life settlement securitization is yet a nascent field. Moreover, most life settlement securitizations are executed as private placements, so data on them is not generally available.¹²⁹ A 1995 report refers to an early securitization by Ironwood Capital Partners of viatical settlements of AIDS victims with a combined face value of \$35 million.¹³⁰ Since then, only a few life settlement securitizations have been reported publicly. Legacy Benefits Life Insurance Settlements issued bonds in 2004 on a \$70.3 million face value pool of policies and annuities. Moody's rated the bonds A1 and Baa2, based on "mortality projections . . . [and] the credit quality of the insurance and annuity providers, most of which currently hold a Moody's financial strength rating of Aa3 or better . . ." ¹³¹ Moody's ratings utilized Monte Carlo simulation, a method of modeling random events, to gauge policy-seller mortality, testing the medical assessments by Legacy's hired evaluators.¹³² Risk Finance, a subsidiary of the troubled American International Group (AIG), executed a larger securitization in 2009. A.M. Best Co. rated the bonds, which were worth over \$2 billion and backed by life insurance policies with combined face value of \$8.4 billion.¹³³ These few publicly known securitizations have grown significantly in value but so far "appear to have had little or no impact on the life settlement or life insurance markets."¹³⁴

128. Press Release, Swiss Re, Swiss Re Completes USD 245 Million Securitisation of In-Force Life Insurance Policies (Jan. 21, 2005), available at http://www.swissre.com/media/news_releases/swiss_re_completes_usd_245_million_securitisation_of_in-force_life_insurance_policies.html.

129. *Securitization Hearings*, *supra* note 17, at 3 (statement of Daniel Curry, President, DBRS Inc.).

130. *Life Insurance Policies of AIDS Patients Packaged as Securities*, BLOOMBERG, Mar. 2, 1995.

131. Press Release, Moody's Investor Serv., Moody's Rates Legacy Life Settlement Securitization A1 and Baa2 (Mar. 16, 2004), available at http://legacybenefits.com/images/doc/Moodys_20Press_20Release-031604.pdf.

132. *Id.* For an example of Monte Carlo simulation applied to health outcomes, see Janet M. Box-Steffensmeier & Suzanna De Boef, *Repeated Events Survival Models: The Conditional Frailty Model*, 25 STAT. MEDICINE 3518 (2006).

133. Nancy Leinfuss, *Wall Street Plays Death Card in Securitization Market*, REUTERS, July 31, 2009, <http://www.reuters.com/article/idUSTRE56U5UX20090731>.

134. Arthur D. Postal, *Life Settlement Securitizations Pose No Systematic Threat*, LISA Asserts, NAT'L UNDERWRITER LIFE & HEALTH INS. NEWS, Oct. 5, 2009, available at

E. Reactions to Life Settlement Securitization

Securitization has been limited, in part, because market participants remain wary of the risks and difficulties particular to securitizing life insurance products. Standard & Poor's (S&P), for example, has said it does not plan to rate life settlement securitizations for the foreseeable future.¹³⁵ Chief among the firm's reasons was the still limited supply of policies, which has prevented many would-be securitizers from gathering enough policies to achieve statistical credibility. S&P also cited legal concerns that underlying policies might be deemed void for lack of insurable interest, presumably as a result of STOLI. S&P further noted that there is yet little data comparing mortality projections to actual outcomes. Settlement providers do not retain enough risk in securitizations, and settlement securitizations may in fact be correlated to other economic risks because, if an economic downturn causes insurer insolvencies, traditional beneficiaries may receive superior treatment to investors.¹³⁶

In February 2010, the American Council of Life Insurers (ACLI) called for life settlement securitization to be prohibited by legislation or regulation.¹³⁷ The group asserted that securitization would encourage settlement providers to prey on elderly insureds and to instigate STOLI transactions. Further, securitization would create untenable risks for investors because settlement providers would be separated from risk, STOLI losses would be total (unlike mortgage defaults, which at least leave investors with a physical asset), and securitizers would not be able—partly because of privacy protections—to share enough information for investors to conduct sufficient due diligence.¹³⁸

The Institutional Life Markets Association (ILMA) accused ACLI of confusing STOLI with bona fide life settlements. ILMA's statement named several

<http://www.lifeandhealthinsurancenews.com/Issues/2009/Oct-5th-2009/Pages/Life-Settlement-Securitizations-Pose-No-Systemic-Threat-LISA-Asserts.aspx> (quoting Steven H. Strongin, Managing Director, Head of Global Investment Research, Goldman, Sachs & Co.).

135. Trevor Thomas, *Life Settlement Securitizations Leave S&P Cold*, NAT'L UNDERWRITER LIFE & HEALTH INS. NEWS, Oct. 15, 2009, available at [http://www.lifeandhealthinsurancenews.com/News/2009/10/Pages/Life+Settlement-Securitizations-Leave-SP-Cold.aspx?co.](http://www.lifeandhealthinsurancenews.com/News/2009/10/Pages/Life+Settlement-Securitizations-Leave-SP-Cold.aspx?co;); see also A.M. BEST CO., A.M. BEST METHODOLOGY: LIFE SETTLEMENT SECURITIZATION 1 (2009), available at <http://www.ambest.com/debt/lifeselement.pdf> (explaining why life settlement securitizations are rare).
136. Thomas, *supra* note 135.
137. Press Release, Am. Council of Life Insurers, Statement of the ACLI Regarding Securitization of Life Settlements 1 (Feb. 3, 2010), available at http://www.acli.com/NR/rdonlyres/972B2B38-89Fo-4683-B236-A01360544A9F/23344/STOLI_SecuritizationPolicyFinal_020310.pdf.
138. *Id.* at 1-2.

benefits of securitization, including lowering the cost of borrowing for settlement providers and professionalizing the asset management and servicing of policies.¹³⁹ LISA echoed ILMA, stating that the ACLI statement was “sensationalistic nonsense,” denying that securitization would increase incentives for STOLI, and arguing that unscrupulous insurance agents are the root of the STOLI problem.¹⁴⁰

Life settlement executives made similar responses to a September 2009 *New York Times* article. One provider, David Mickelson, asserted that life settlement securitization would not create the risks attributed to MBS. He pointed out: “[E]ach policy has the backing of an insurance institution with a rating no lower than AA . . . And the insurance industry has a perfect record of always paying death claims.”¹⁴¹ The assertion is true,¹⁴² though many states’ insurance guaranty laws cover life insurance claims up to only \$300,000,¹⁴³ which would reflect a significant payout reduction for many high-face-value policies. Mickelson added that an elderly person’s longevity is very unlikely to be extended by more than twenty to forty months¹⁴⁴—but analysis indicates that a forty-month extension on an average policy could reduce investor profit from 13% to less than 5%.¹⁴⁵

Life settlement-backed CDOs are already considered securities by the SEC. However, noting the “potentially far-reaching consequences of the recent movement toward securitization of life settlements,” the SEC has established a Life Settlements Task Force to explore regulatory options for the future.¹⁴⁶ This Note similarly seeks to determine whether life settlement securitizations could create problems—particularly problems that resemble causes of the late financial crisis.

139. Press Release, Institutional Life Mkts. Ass’n, ACLI Mixes “Apples and Oranges” to Mislead Consumers (Feb. 4, 2010), available at <http://www.lifemarketsassociation.org/documents/PR-%20ACLI%20misleads.pdf>.

140. Bob Graham, *Life Insurers, Life Settlement Group Spar over Securitization*, INS. & FIN. ADVISOR, Feb. 9, 2010, <http://ifawebnews.com/2010/02/09/life-insurers-life-settlement-group-spar-over-securitization>.

141. Trevor Thomas, *Settlement Executives Comment on Times Article*, NAT’L UNDERWRITER LIFE & HEALTH INS. NEWS (Sept. 14, 2009), available at <http://www.lifeandhealthinsurancenews.com/Exclusives/2009/09/Pages/Feature-Settlement-executives-comment-on-Times-article.aspx>.

142. LOUIS A. MEZZULLO, AN ESTATE PLANNER’S GUIDE TO LIFE INSURANCE 2 (2000).

143. See, e.g., FLA. STAT. § 631.717(9) (2010); MASS. GEN. LAWS ANN. ch. 175, § 146B(4)(B)(3)(b)(i) (2009); VA. CODE ANN. § 38.2-1704(1)(2)(a) (2010).

144. Thomas, *supra* note 141.

145. KAMATH & SLEDGE, *supra* note 36, at 5, ex.6.

146. *Securitization Hearings*, *supra* note 17, at 4 (statement of Paula Dubberly, Associate Director, Division of Corporate Finance, United States Securities and Exchange Commission).

II. FRICTIONS AND RISKS IN VIATICAL AND LIFE SETTLEMENT SECURITIZATION

This Part compares the securitization process for life insurance settlements to that for mortgages, focusing on the sources of risk that have contributed to the recent financial crisis. In establishing a framework for this discussion, I draw on the analysis of subprime mortgage securitization conducted by Adam Ashcraft and Til Schuermann of the Federal Reserve Bank of New York.¹⁴⁷ Their work represents the consensus view¹⁴⁸ of the sources of risk in mortgage securitization and identifies seven “key frictions”—interactions between actors in which divergent interests and informational disparities or deficiencies have potential to increase risk. These are frictions between: (1) mortgagor and lender; (2) lender and securitization arranger; (3) arranger and third parties; (4) servicer and mortgagor; (5) servicer and third parties; (6) asset manager and investor; and (7) investor and credit rating agencies. The authors explain how “[f]ive frictions caused the subprime crisis”: frictions 1, 2, 3, 6, and 7.¹⁴⁹

Before comparing securitization in mortgages and life settlements, it is important to clarify how roles in the two processes correspond to each other. Most importantly, the individual insured in a life insurance settlement corresponds to the lender in a mortgage transaction, not the borrower: the lender and the insured are the two parties who sell their contractual entitlements for securitization.¹⁵⁰ Likewise, insurers and mortgagors are the parties whose payments fund the payouts of asset-backed bonds.

The remaining actors correspond in a fairly straightforward manner. A life settlement provider plays the part of the arranger who buys the contractual right and organizes a securitization. For the sake of simplicity, I generally assume (as Ashcraft and Schuermann do)¹⁵¹ that each of the roles described above is played by a single party. In the mortgage context, there is often a broker who brings together a borrower and a lender.¹⁵² An individual typically buys an insurance policy through an insurance agent, who represents any number of insurers in sales but is not directly employed by any one insurance firm. Brokers can also bring together buyers and sellers in the secondary market for life insur-

147. Ashcraft & Schuermann, *supra* note 21.

148. Ashcraft and Schuermann’s work is valuable because it outlines the universe of factors that observers have found important to explaining the financial crisis, though there is naturally disagreement over which sources of risk are most important. Some commentators argue, for example, that the originate-to-distribute lending model, *infra* note 160 and accompanying text, was not particularly influential in the current crisis. See, e.g., Schwarcz, *supra* note 35, at 1318-21.

149. See Ashcraft & Schuermann, *supra* note 21, at i-ii.

150. Doherty & Singer, *supra* note 30, at 457-58.

151. Ashcraft & Schuermann, *supra* note 21, at 5.

152. *Id.*

ance.¹⁵³ Finally, life settlement providers may sell policies to an independent entity that arranges securitization.¹⁵⁴ An additional intermediary means an additional point of friction that can increase risk.¹⁵⁵ These intermediaries are not, however, essential to securitization, and this Note will only discuss the additional problems they may create (agency issues and information asymmetries) when particularly important. The relevant third parties in the mortgage context are CRAs and asset managers (agents of investors).¹⁵⁶ The same is true for insurance settlement securitization, with the addition of medical underwriters who provide life expectancy analysis to support the settlement provider and rating agency.¹⁵⁷ Finally, the roles of servicers, asset managers, and investors are analogous in the two securitization contexts.

Of the seven frictions identified by Ashcraft and Schuermann, five are found in both mortgage and life settlement securitization. This Part does not extensively discuss the two other frictions, which are not relevant to insurance settlement securitization.¹⁵⁸ This Part also identifies three frictions unique to insurance settlement securitization. These frictions concern the special relationships between (8) investors and insurers' other creditors; (9) investors and insureds; and (10) investors and insureds' survivors. A concluding Section presents

153. Treaster, *supra* note 53.

154. A.M. BEST Co., *supra* note 135, at 11.

155. Such intermediaries have indeed caused problems in the life settlement industry. Recall New York Attorney General Eliot Spitzer's allegations of a life settlement provider's bribing brokers to ignore other providers' bids. See Complaint, *supra* note 59, at 2.

156. Ashcraft & Schuermann, *supra* note 21, at 6-7. I do not discuss warehouse lenders, to which Ashcraft and Schuermann give some attention. *Id.*

157. A.M. BEST Co., *supra* note 135, at 1, 5.

158. These frictions—4 and 5—both involve the mortgage servicer employed by an SPV to collect payments, provide customer service to mortgagors, supervise foreclosures, and handle other administrative tasks. Ashcraft & Schuermann, *supra* note 21, at i, 7. Life settlement securitizations also require servicers to monitor the life/death status of insureds and perhaps collect death benefits from insurers. A.M. BEST Co., *supra* note 135, at 2. However, this servicer would not encounter the same frictions seen in mortgage securitization. Friction 4 reflects moral hazard in a mortgagor's reduced incentive to care for property once a servicer appears likely to foreclose. Ashcraft & Schuermann, *supra* note 21, at i, 7. Insurers on the other hand have strong incentives to pay death benefits (judicial contract enforcement and reputational incentives). Friction 5 concerns servicers' incentives to delay foreclosure and continue collecting fees at the expense of investors and others. *Id.* at i-ii, 8-9. Life settlement servicers may also want to keep policies on the books, but they have little ability to delay a policy's end. Ashcraft and Schuermann also note that mortgage servicers have incentive to inflate reimbursable expenses incurred during foreclosures. *Id.* Life settlement servicers have a similar incentive but no duty as costly as foreclosure. Any effect of this moral hazard promises to be minor.

findings on the overall similarity in risk structure between the two types of securitization and how risks might be realized in an enlarged market for life settlement-backed securities.

A. *Frictions Common to Mortgage and Insurance Settlement Securitization*

Five frictions in mortgage securitization—precisely the ones identified as causing the subprime crisis—also appear in life settlement securitization. They are the frictions between: (1) mortgagor/insurer and lender/insured; (2) lender/insured and securitization arranger/settlement provider-arranger; (3) arranger/settlement provider-arranger and third parties; (6) asset manager and investor; and (7) investor and CRAs.¹⁵⁹ This Section demonstrates how each friction functions in the two contexts.

Friction 1: Insurer and Insured. In the mortgage context, this friction takes the form of a lender's originate-to-distribute mindset and predatory lending. That is, lenders who believe they can lend more than the borrower can repay but nevertheless sell the loan have an incentive to lend too much.¹⁶⁰ This tendency mirrors the incentive of borrowers, particularly unsophisticated ones motivated by pressing short-term needs, to borrow too much.¹⁶¹ The risk is straightforward: a borrower with too large a loan is likely to default to the detriment of whoever bears the loan's credit risk.

In the life insurance context, the friction between insurer and insured centers on STOLI and insurance fraud.¹⁶² Insurers stand to lose when they are defrauded into accepting risk they would normally refuse, given honest information. As discussed above, policies transferred to investors are far less likely to lapse than insurers project, magnifying the effects of such fraud.¹⁶³ Even if fraud or policy-voiding STOLI is discovered, insurers are likely to suffer the costs of litigating disputes.¹⁶⁴

For a securitization, however, the greater significance of fraud and STOLI is that courts may find the associated insurance contracts *void ab initio*.¹⁶⁵ A secu-

159. Ashcraft & Schuermann, *supra* note 21, at i-ii.

160. For a fuller discussion of originate-to-distribute, see Benjamin J. Keys et al., Did Securitization Lead to Lax Screening? Evidence from Subprime Loans (Dec. 25, 2008) (unpublished manuscript), available at <http://ssrn.com/abstract=1093137>.

161. Ashcraft and Schuermann limit their discussion of Friction 1 to predatory lending but later note that the same transaction could be construed as either predatory lending or borrowing. Ashcraft & Schuermann, *supra* note 21, at 5-6.

162. I focus on the relationship between insurers and individual insureds, but it should be noted that employers and creditors can also buy and sell insurance on the lives of employees and borrowers.

163. See *supra* notes 54-55 and accompanying text.

164. Jensen & Leimberg, *supra* note 65, at 123.

165. See *supra* note 76 and accompanying text.

ritized pool of policies would lose all value attributed to the voided policies, and bondholders' profits would be reduced, absent recovery from the insured (or the insured's estate), the settlement provider, or another intermediary. Investors have a strong argument that policy sales into the SPV include implied warranties that the policies were legal and valid—unless such warranties are explicitly eliminated through contract.¹⁶⁶ Even with warranties, though, investors would likely incur significant litigation costs to pursue recovery—and may still fail to recover if defendants cannot pay.

This discussion raises the question posed by ACLI: Will securitization encourage an increase in STOLI transactions or other types of fraud by insurance applicants? Securitization is likely to encourage both. As Steven Schwarcz discusses, “securitization of a flawed asset type can motivate greater origination of that asset type.”¹⁶⁷ Securitization serves—ideally—to isolate and clarify risk. Investors are willing to pay more for such clarity. Higher prices in turn increase demand in the secondary market for the underlying assets.¹⁶⁸ To any individuals and settlement providers who perceive the ability to sell or securitize policies with limited exposure to risk, higher prices on the secondary market provide incentives to engage in fraud. Furthermore, the information advantage of insurance applicants, who are intimately aware of their own health, facilitates the execution of fraud.

The flip side of this friction is not a concern in settlement securitization. While the mortgage securitization business must contend with both predatory borrowing and lending, there is no significant risk of insurers issuing policies against their own economic interest. A lender who is divorced from default risk and an unsophisticated borrower who is interested in near-term cash may both eagerly agree to oversized loans. Insurers are sophisticated parties, quite cognizant of traditional risks, and interested in long-term profit; their goal is to insure healthy people who live for many years, not to insure those near death. Still, some proponents of life settlements have accused insurance agents of ineffective (i) discovery and (ii) denial of STOLI applications.¹⁶⁹

Friction 2: Insured and Settlement Provider. When a lender sells loans to a securitization arranger, the lender has a strong information advantage regarding the credit-worthiness of borrowers. Further, the lender has incentive to exaggerate the quality of the loan to achieve a higher sales price. The general solution

166. See 6 AM. JUR. 2D *Assignments* § 125 (2010) (“Although an assignment is made ‘without recourse,’ there is an implied warranty that the right as assigned actually exists and is subject to no limitations or defenses other than those stated or apparent at the time of the assignment.” (citing *Penowa Coal Sales Co. v. Gibbs & Co.*, 85 A.2d 464 (Md. 1952)); cf. U.C.C. § 2-315 (2004) (imposing implied warranties in the sale of goods).

167. Schwarcz, *supra* note 35, at 1318.

168. After securitization of subprime mortgages began, origination and issuance of such mortgages rose significantly. See Ashcraft & Schuermann, *supra* note 21, at 2.

169. See Graham, *supra* note 140.

to such friction is due diligence by the arranger,¹⁷⁰ but arrangers may have contributed to the recent crisis through their carelessness.¹⁷¹ In addition, the lender usually makes representations and warranties (R&W) about the mortgagor and underwriting process that, if violated, may obligate the lender to repurchase the affected loans.¹⁷²

The same is true of an insured negotiating the sale of a policy to a settlement provider. The insured knows more about his or her own health and has an incentive to exaggerate health problems to win a higher sales price. Like mortgage securitization arrangers, settlement providers attempt to resolve this friction through due diligence, provided in part by medical underwriters.¹⁷³ These underwriters are engaged by settlement providers to examine medical records and estimate life expectancies of would-be policy-sellers.¹⁷⁴ The underwriters typically use a system developed by reinsurers to measure an insured's mortality risk based on demonstrated medical conditions against a standard risk. Most medical underwriters today reportedly base their calculations on a common dataset, the 2008 Valuation Basic Table.¹⁷⁵

A.M. Best reports, however, that medical underwriters do not have a strong record of accurately estimating life expectancies. In a comparative study by A.M. Best, three medical underwriters produced widely divergent life expectancies for the same group of two hundred lives: Average life expectancies from two of the firms were twenty-four months apart. However, A.M. Best says that the underwriters have improved their accuracy over time and may improve further as more historical data becomes available.¹⁷⁶

Still, the errors in life expectancy predictions and market intermediaries' incentives to exploit such error remain significant. Policy-sellers do provide information about their health status to settlement providers just as lenders make R&Ws regarding mortgages. However, the ultimate owner of the policy is likely stuck with any losses, unless they can prove fraud by the insured.

Friction 3: Settlement Provider/Securitization Arranger and Third Parties. A mortgage securitization arranger may have an incentive to keep the most promising mortgages for itself and securitize the rest.¹⁷⁷ The arranger can accomplish

170. Ashcraft & Schuermann, *supra* note 21, at 5-6.

171. Patrick Rucker, *Wall Street Often Shelved Damaging Subprime Reports*, REUTERS, July 27, 2007, <http://www.reuters.com/article/idUSN2743515820070727>.

172. Ashcraft & Schuermann, *supra* note 21, at 5-6.

173. A.M. BEST Co., *supra* note 135, at ex.2, 5-10.

174. *Id.* at ex.2 (noting that when a provider intends to re-sell the policy to a separate securities issuer, industry standards call for the provider to engage at least two medical underwriters).

175. *Id.* at 5-6.

176. *Id.* at 7-8; see also Thomas, *supra* note 135 (noting S&P's observation that there is currently insufficient data comparing projected to actual mortality).

177. Ashcraft & Schuermann, *supra* note 21, at 6.

this adverse selection because of the information advantage it has over third parties: the arranger knows more about the loans than do either the credit rating agency or investors or their asset managers. A classic “lemons problem” may result: buyers distrust sellers and discount their offers, which incentivizes sellers to hold back more top-quality assets, and a market-destructive cycle begins.¹⁷⁸ Alternatively, buyers may overly trust sellers and pay high prices for risky investments. This friction is exacerbated if the arranger does not retain ownership of any of the securities issued—especially the most junior, equity tranche of bonds. The arranger is then completely divorced from the risk that the securities will fail to generate profit.¹⁷⁹ The arranger’s incentive becomes maximizing the sales price, not ensuring the quality of the underlying assets.

A well-functioning market mitigates such problems. Since securitization arrangers must depend on their reputations to sell investments, they have incentives to ensure their customers’ satisfaction with the purchase price and profit earned. Due diligence by investors, asset managers, and CRAs should help assure that prices are reasonable.¹⁸⁰ As the subprime crisis demonstrated, however, these safeguards are not foolproof.

In a life settlement securitization, the lemons problem is lessened when more individualized data is available to all parties, reducing the settlement provider’s informational advantage. While settlement providers have the same motivation to retain the best assets in-house, they may be forced to share medical and other information regarding the policies to be securitized (though not patient identities protected by privacy laws). Third parties in a mortgage securitization make generalized estimations about default rates based on demographic information such as local “unemployment rates, interest rates, and home price appreciation.”¹⁸¹ Third parties in life settlement securitizations are better able to base their decisions on relatively specific information about each patient’s medical condition. Knowing that a pool of insureds includes victims of certain diseases diagnosed at certain times is simply more helpful in estimating life expectancies than is information on mortgagors’ neighborhoods in projecting default rates. Whereas arrangers have a relative advantage in predicting which mortgagors are likely to make their payments, a settlement provider is on more equal footing with third parties in estimating when a given insured will die. Still, the incentive to raise the sale price persists, as does the friction. The settlement provider-arranger always wants to make its assets appear more valuable than they truly are, especially if the arranger retains no ownership of the securities issued.

178. *Id.* at 6-7.

179. *Id.* at 12.

180. *Id.* at 6-7.

181. *Id.* at 43.

Friction 6: Asset Manager and Investor. This friction is a classic principal-agent problem.¹⁸² Unsophisticated investors—pensioners in a pension fund, for example—typically employ a portfolio or asset manager to handle their investments. These investors may be ill-equipped to distinguish between a savvy manager and one that is less capable. Since these investors will not closely monitor their investments, the asset manager has reduced incentive to conduct thorough due diligence.¹⁸³ Fiduciary obligations of investment advisors do reduce this friction, but such obligations are typically weak, requiring only a minimal level of care.¹⁸⁴ The friction is further mitigated by evaluations of asset managers against benchmarks or peers—or by restricting the investments that asset managers can make. If these restrictions are defined by credit ratings, however, they serve to magnify the influence of credit ratings on investors' fortunes.¹⁸⁵ Friction 6 equally applies to life settlement securitization.

Friction 7: Investor and Credit Rating Agencies. CRAs created models to estimate the income expected from pools of mortgages and, therefore, the profit expected from MBS.¹⁸⁶ Investors relied heavily on the resulting bond ratings.¹⁸⁷ However, a host of weaknesses in the credit rating process caused CRAs to signal too much confidence in inherently risky assets. The most important of these weaknesses arises because the mathematical structure of securitization causes even small model errors to drastically distort expected income and the resulting rating. This effect is magnified in what some refer to as CDO-squared (CDO²), in which asset-backed securities themselves are pooled and resecuritized.¹⁸⁸

Model errors can have any number of sources. For example, since CRAs base their ratings on available historical data, errors become more likely—and ratings become less reliable—when data is scarce. Wall Street faced such a paucity of data concerning default rates of subprime mortgages when it began securitizing them.¹⁸⁹ A second sort of error resulted from CRAs' misjudgment of correlation among the events they were predicting, namely mortgage defaults. CRAs did not sufficiently recognize that a default might reflect underlying con-

182. For a deeper discussion of principal-agent problems, see David E.M. Sappington, *Incentives in Principal-Agent Relationships*, 5 J. ECON. PERSP. 45 (1991).

183. Ashcraft & Schuermann, *supra* note 21, at 9-10.

184. See, e.g., *Navellier v. Sletten*, 262 F.3d 923, 946-47 (9th Cir. 2001) (affirming dismissal of investors' claims because advisors enjoyed Delaware's business judgment protection).

185. Ashcraft & Schuermann, *supra* note 21, at 9-10.

186. *Id.* at 44.

187. *Id.* at 61-65.

188. See Joshua Coval, Jakub Jurek & Erik Stafford, *The Economics of Structured Finance*, 23 J. ECON. PERSP. 3, 7, 9 (2009).

189. See *id.* at 15.

ditions that raised the likelihood of many other, simultaneous defaults.¹⁹⁰ For example, a given default might correlate to many others because they are all brought about by a downturn in the broader economy. As it happened, CRAs often issued ratings to MBS without factoring in the possible ill-effects of an economic recession.¹⁹¹ Other possible sources of model error include conflict of interest for CRAs, which are typically paid by securitization arrangers,¹⁹² and CRAs' hesitation to correct prior errors in order to protect their reputations.¹⁹³

All of these weaknesses in the credit rating process apply to securitization of life settlements to differing degrees. Because life settlement securitizations share the same structure as mortgage securitizations, the two also share the mathematical vulnerability to even modest imprecision in model assumptions. However, as a result of the scarcity of settled policies, resecuritizations—creations of life settlement-backed CDO²—are unlikely to occur.¹⁹⁴ As such, the magnified vulnerability of CDO² to model error is unlikely to affect life settlement securitization in the foreseeable future.

As they did with subprime securitizations, CRAs suffer from a lack of dense historical data on which to base judgments about life settlement-backed securities. Medical underwriters are responsible for gauging life expectancies for insureds represented in a pool of insurance policies, and, as noted above, their predictions are not reliably accurate.¹⁹⁵ This weakness may also be exacerbated by the fact that CRAs receive life expectancy data from medical underwriters, often with supporting proprietary calculations redacted. Thus the CRAs cannot make independent judgments on the data.¹⁹⁶ As a result, while they may adjust life expectancies as they believe appropriate, CRAs necessarily base ratings in part on faith that the medical underwriters' calculations are accurate. Additionally, CRAs must estimate the extent to which STOLI will destroy value within a pool of insurance policies. Here, too, reliable historical data is scarce.

190. *See id.* at 7, 16.

191. *See id.* at 17.

192. *See* Joseph R. Mason & Joshua Rosner, *Where Did the Risk Go? How Misapplied Bond Ratings Cause Mortgage Backed Securities and Collateralized Debt Obligation Market Disruptions* (May 14, 2007) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1027475.

193. Ashcraft & Schuermann, *supra* note 21, at 58-59.

194. Following the subprime panic, CDO² transactions may long remain rare for all securitizations. *See* Schwarcz, *supra* note 35, at 1325.

195. *See supra* note 176 and accompanying text. While life expectancy data for the general population is robust, data concerning insureds who sell their life insurance policies is relatively new and thin. An A.M. Best finding that medical underwriters have become more conservative in their life expectancy estimations may suggest, unsurprisingly, that a person in this population typically lives longer than an average person of a similar profile from the general population. A.M. BEST Co., *supra* note 135, at 7.

196. A.M. BEST Co., *supra* note 135, at 19.

Correlation risk applies to life insurance settlement investments, as demonstrated by the viatical crash of the mid-1990s in response to improved AIDS medications.¹⁹⁷ Investment in a pool of AIDS victims' insurance policies is vulnerable to the discovery of a cure, just as an MBS is vulnerable to any stimulus that causes mortgagors to default simultaneously. However, this correlation risk can be significantly mitigated through disease diversity. By ensuring that no one disease affects too large a portion of a securitized pool of life insurance, arrangers and CRAs can limit—but not eliminate—the influence of new treatments on investment value.¹⁹⁸ CRAs must also contend with universally rising life expectancies, though sudden, dramatic, and widespread life expectancy extensions are generally unlikely.¹⁹⁹ Accounting for all of these differences, correlation risk can be more effectively managed in life settlement securitization than in the MBS context.

The broader economy affects life settlements less than mortgages,²⁰⁰ but life settlements' non-correlative nature can be exaggerated. Mortality has little to do with economic cycles,²⁰¹ but insurance death benefits are collected only if insurers pay them. Insurers have a strong record of paying death benefits,²⁰² but as S&P notes, how investor-owned policies will fare in future insurer insolvencies remains unknown. Conceivably, a legislature or court could give priority to traditional beneficiaries.²⁰³

The potential conflict of interest resulting from CRAs' employment by securitization arrangers is present in the life settlement securitization environment, though it may be weaker than in mortgage securitization. Currently, life settlement securitizations are rare, and CRAs do not depend on them for significant business.²⁰⁴ Accordingly, undue pressure to pander to arrangers by inflating credit ratings is low. In contrast, at the mortgage securitization bubble's peak in 2006, Moody's reported that 44% of its revenue came from issuing ratings on structured financial products, largely MBS.²⁰⁵

Lastly, CRAs' hesitance to downgrade prior ratings on MBS applies to securitizations of life settlements as well, though perhaps to a lesser degree. Since the

197. See *supra* note 14 and accompanying text.

198. A.M. BEST Co., *supra* note 135, at 6, 14; Anderson, *supra* note 27.

199. *The Future of Human Longevity: How Vital Are Markets and Innovation?: Hearing before the S. Spec. Comm. on Aging*, 108th Cong. 108-92 (2003) (statement of J.W. Vaupel, Director, Max Planck Institute for Demographic Research).

200. See *supra* note 29 and accompanying text.

201. *Id.*

202. See MEZZULLO, *supra* note 142.

203. Thomas, *supra* note 135; see also discussion of Friction 8, *infra* Section II.B, notes 206-211 and accompanying text.

204. See *supra* notes 129-134 and accompanying text.

205. Coval, Jurek & Stafford, *supra* note 188, at 4.

life settlement market is smaller than the mortgage market, CRAs may feel less embarrassed to admit mistakes related to life settlements. This may also reduce fears about the systemic impact of downgrades. Additionally, agencies may have emerged from the MBS crisis predisposed to respond to deteriorating situations with quicker downgrades.

B. Frictions Unique to Insurance Settlement Securitization

Three additional frictions, not applicable to mortgage securitization, may substantially affect life settlement securitization: frictions between (8) investors and insolvent insurers' other creditors; (9) the insured and third parties; and (10) investors and insureds' survivors.

Friction 8: Investors and Insurers' Other Creditors. When mortgagors become insolvent and cannot pay home mortgage payments, mortgagees typically enjoy a clear right to repossess the home. Investors buy life settlement-backed securities expecting that when their servicer files a death claim with an insurer, the insurer will pay benefits into the SPV that owns the decedent's life insurance policy. But what if the insurer is insolvent? Although subject to state requirements concerning capitalization and reserve maintenance,²⁰⁶ insurers may invest much of their wealth, and losing investments sometimes lead to insolvencies. States often restrict insurers to seemingly safe investments,²⁰⁷ such as highly rated bonds. As a result, insurance firms purchased large numbers of MBS before the Great Recession.²⁰⁸ Insurer insolvencies have remained rare, but some insurers have collapsed, such as the giant AIG.²⁰⁹

This example reflects that insurer insolvencies occur most often during times of economic crisis—when seemingly safe investments plummet in value. State guaranty laws, which safeguard payments to policyholders, govern standard insurer insolvencies.²¹⁰ Investors may ultimately enjoy equal treatment in insurer insolvencies, but in a severe economic crisis, a court, legislature, receiver, or trustee could prioritize payments to struggling families over Wall Street investors. Fear of this sort of subordination was one reason cited by S&P for ab-

206. See 1 GEORGE J. COUCH, COUCH ON INSURANCE 3d 2:27-2:29 (Steven Plitt et al. eds., 2009).

207. See *id.* at 2:30.

208. Gorton, *supra* note 41 (manuscript at 43).

209. See PETER G. GALLANIS, NT'L ORG. LIFE & HEALTH INS. GUARANTY ASSOCS., THE LIFE AND HEALTH INSURANCE GUARANTY SYSTEM, AND THE FINANCIAL CRISIS OF 2008-2009, at ex.1A (2009), available at <http://www.nolhga.com/resource/file/NOLHGAandFinancialCrisis.pdf>; see also Gretchen Morgenson, *Behind Insurer's Crisis, Blind Eye to a Web of Risk*, N.Y. TIMES, Sept. 27, 2008, at A1 (discussing the collapse of AIG).

210. See, e.g., FLA. STAT. §§ 631.711-737 (2010); MASS. GEN. LAWS ch. 175, § 146B (2009); VA. CODE ANN. §§ 38.2-1700-1721 (2010).

staining from life settlement securitization rating altogether.²¹¹ The magnitude of this risk to investors is unclear, but it does indicate that life settlement-backed securities can be vulnerable to the vicissitudes of the broader economy, as discussed vis-à-vis CRAs under Friction 7.

Friction 9: Investors and Insureds. Friction 1 explored the view that the originate-to-distribute model of lending created moral hazard, encouraging lenders to issue mortgages with a high likelihood of default, but mortgage originators certainly have no affirmative interest in causing a loan to fail. Mortgagors, though they would rather not make payments, stand to lose dearly in default and have no interest in destroying their property. Though different parties to a mortgage oppose each other as debtor and creditor, all parties have aligned interests in seeing loans repaid without foreclosure and with homes intact.

In a life settlement, insureds usually seek an outcome that destroys investor value: not dying. Moreover, when an insured's life expectancy is extended through treatment or otherwise, the insured need not inform investor, servicer, or settlement provider. The servicer may periodically contact the insured to determine whether the insured is alive,²¹² but Health Insurance Portability and Accountability Act (HIPAA) regulations allow insureds to revoke, at any time, previous authorization for access to medical records.²¹³ Regulations generally forbid medical professionals from sharing personal health information with anyone other than the patient without patient authorization.²¹⁴ A.M. Best advises security-issuers to offer insureds incentives to continue providing health information or seek limited powers of attorney so that up-to-date health information will be available during the rating process; the rating agency warns, however, that enforcement of powers of attorney may not be practical, and continual access to the insured's health information is unlikely.²¹⁵ This will remain true unless medical privacy laws change significantly.

Investors in MBS suffer a similar lack of information regarding the financial health of mortgagors, but to a lesser degree. Servicers receive warning about potential defaults when mortgagors miss payments. Also, a mortgagor in deteriorating financial condition may contact the servicer to negotiate loan restructuring. This contact provides data to the servicer, and hence to investors, about the state of the mortgages and the health of the investment. By contrast, investors in life settlement-backed securities likely cannot obtain up-to-date health information on insureds and, therefore, cannot know about changes in the expected value of their investment, which insureds have an interest—and sometimes an ability—to diminish.

211. See Thomas, *supra* note 135.

212. VIATICAL SETTLEMENTS MODEL ACT § 10(G) (Nat'l Assoc. of Ins. Comm'rs 2008).

213. 45 C.F.R. § 164.508(b)(5) (2009).

214. See 45 C.F.R. § 164.502 (2009).

215. A.M. BEST CO., *supra* note 135, at 9.

Friction 10: Investors and Insured's Survivors. Investors in MBS do not ultimately depend on the help of mortgage lenders to collect payments. However, if a life insurer denies a death claim, investors in life settlement-backed securities may require assistance from the insured's survivors. Insurers can deny claims based on an assertion that the insured's death was not covered—or on allegations of insurance fraud or lack of insurable interest. In all of these cases, investors may need evidence in the possession of the insured's grieving survivors, who may be disinclined to help investors.

Investors may seek court orders to compel survivors to help, and if the insurer succeeds in denying the claim, investors may have a contract claim against the insured's estate for selling an invalid policy. But such action would incur litigation costs and possibly encounter statute of limitations issues. This friction—the separation of the survivors' information from the beneficial interest in the policy—injects additional uncertainty into the value of a life settlement.

C. *The Frictions' Net Effect*

Fundamental differences between mortgage and life settlement securitization make it difficult to determine which is more plagued by the various frictions, but it is safe to say that enough informational asymmetries, ambiguities, and divergent interests exist to cause serious problems in life settlement securitization. The life settlement market's smaller size will mean its influence on the broader economy is less than that of mortgage securitization. Recall that projections on life settlements stop short of predicting \$200 billion in settled life insurance by 2030,²¹⁶ though the market could expand more, given the \$19.1 trillion in life insurance policies in force at the end of 2008.²¹⁷ Still, a crisis that costs billions of dollars is always significant, and there are several ways that losses from a life settlement crisis could become greater than expected. For example, a significant prevalence of STOLI—perhaps brought on by securitization-spurred demand for settlements as discussed under Friction 1—could cause market growth beyond current projections and could cause a crisis in which significant investment value is completely erased.

A life settlement crisis could also have stronger impact if, for example, baby-boomers increasingly retire without sufficient savings. The life settlement market could then grow more than expected in size and effect on the national economy. The widespread misperception that life settlements are immune from economic downturns could also lead to more investment than currently projected. Other exogenous events could also exacerbate the frictions and risks discussed above. Advances in medical technology could significantly prolong life expectancies—perhaps across many diseases—and greatly reduce investment payouts *a la* Frictions 7 (between investors and CRAs) and 9 (between investors and insureds). A major recession, especially one that engenders popular anger

216. KAMATH & SLEDGE, *supra* note 36, at 8.

217. AM. COUNCIL OF LIFE INSURERS, *supra* note 37, at 66.

at Wall Street while also producing insurer insolvencies, could jeopardize investors' interests as discussed under Friction 8. Again, the greater fear must be that after an initial loss of value, a collapse in life settlement securitization could metastasize into a larger crisis if uncertainty gives way to panic.

Moreover, the collapse of life settlement securitization would almost surely have the second-order effect of essentially eliminating demand for life insurance policies in the secondary market. Thus, a crisis would affect investors as well as elderly policyholders in need of settlements. They would suffer especially if, as discussed above, their life expectancies—and, therefore, their need for retirement funds—were significantly increased. This would force elderly policyholders to cope in other ways: working later in life, borrowing or receiving money from their families, or selling other assets such as real estate and financial holdings. This is a disaster worth preventing.

III. PROPOSED REGULATION

How can law serve to resolve frictions in life settlement securitization and reduce associated risks? Congress recently passed, and President Obama signed into law, the Dodd-Frank Wall Street Reform and Consumer Protection Act to overhaul U.S. financial regulation and impose new rules for securitization.²¹⁸ As noted earlier, Steven Strongin of Goldman Sachs has argued that life settlement securitization poses no unique risks and demands no special regulation,²¹⁹ so he would likely urge Congress to go no further than the Dodd-Frank Act.

As explored in Part II, however, the securitization process for life settlements exhibits frictions distinct from other securitizations and manifests now familiar frictions in nuanced ways. While some provisions of the Dodd-Frank Act, as discussed below, help alleviate frictions and risks in life settlement securitization, we still need additional specialized regulation. This Note serves as a warning that Congress's action to date on securitization regulation is too narrow. As the American Bar Association (ABA) Business Law Section asserts, "a 'one size fits all' approach is unlikely to work for securitization, which is more varied in its structures, assets and economics than most observers realize."²²⁰ The failure of Congress to heed this advice may prove costly.

This Part discusses what regulations are appropriate for life settlement securitization, given the likely interpretations of the Dodd-Frank Act. These regulations—several already included in the Dodd-Frank Act and five newly proposed here—divide fairly neatly into four categories. In order of importance to

218. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

219. *Securitization Hearings*, *supra* note 17, at 5 (statement of Steven H. Strongin, Managing Director, Goldman, Sachs & Co.).

220. ABA SECTION OF BUS. LAW, SECURITIZATION IN THE POST-CRISIS ECONOMY 27 (2009), available at <http://www.abanet.org/buslaw/committees/CL112000pub/materials/2010/buslawabalettertocongressassetsecuritizationreportjan252010.pdf>.

life settlement securitization, the categories are: (A) reforms targeting lender, settlement provider, and securitizer incentives; (B) investor protection through credit rating improvements; (C) direct protections for investors; and (D) front-end consumer and insurer protections.

The five proposals introduced here aim to help safeguard the principles of transparency and appropriate interest alignment. These principles are critical because a healthy market in settlement-backed securities requires that all parties be able to discern the risks they assume, and better-positioned actors have sufficiently low incentive to take advantage of other market participants. Again in order of importance, these five new proposals are: (1) risk retention requirements for settlement providers to reduce moral hazard; (2) specialized disclosures by CRAs to clarify risks for investors; (3) a federal prohibition on prioritization of ordinary insurance beneficiaries over investors in insurer insolvencies; (4) a federal STOLI ban; and (5) enhanced insurance applications to prevent STOLI.

A. *Reforms Targeting Lender, Settlement Provider, and Securitizer Incentives*

The Dodd-Frank Act seeks to readjust incentives of lenders and securitizers to eliminate moral hazard and the temptation to create and sell bad debt. The principal mechanism proposed for achieving this goal is the concept of risk retention.²²¹ If lenders or securitizers remain subject to a portion of the credit risk associated with the self-liquidating assets they sell, they will work harder to ensure that those assets are likely to pay off.²²² In theory, this sort of reform would ameliorate Friction 1 by discouraging lending to borrowers who are not likely to repay, and Frictions 2 and 3 by reducing lenders' and securitizers' ability to sell bad debts without putting themselves in peril.

Those who deny that the divorce between risk and influential market actors has played a role in the securitization crisis²²³ may continue to argue that risk retention requirements are unnecessary. Others worry that risk retention may actually increase the likelihood of problems by communicating to market participants that a given risk is reasonable when in fact lenders and securitizers have misjudged risky assets.²²⁴ The ABA's Business Law Section has expressed (somewhat outlandish) concerns that risk retention requirements may have other unintended consequences such as ending securitization altogether.²²⁵ The moral hazard logic, however, appears clear: Asset originators and securitizers are more likely to deal in faulty assets when they face no negative conse-

221. Dodd-Frank Wall Street Reform and Consumer Protection Act § 941(b).

222. See Schwarcz, *supra* note 35, at 1320.

223. See, e.g., *id.* at 1318-21.

224. *Id.* at 1320 n.35.

225. ABA SECTION OF BUS. LAW, *supra* note 220, at 26.

quences;²²⁶ forcing originators to retain some of the risk they create would resolve this problem. Nevertheless, the Dodd-Frank Act calls for a study to assess the likely effects of risk retention requirements and how best to manage them.²²⁷

The new law also calls for federal agencies to determine an appropriate portion of risk for originators and securitizers to retain.²²⁸ Importantly, “originator” is defined as “a person who . . . through the extension of credit or otherwise, creates a financial asset that collateralizes an asset-backed security . . .”²²⁹ The law’s risk retention requirements will help alleviate Friction 3—the incentive and ability of securitizers to exploit third parties in securitization of mortgages, life settlements, and many other asset types. In loan-based securitizations, regulators can also assign some risk to lenders, thereby helping to resolve Friction 2, creating incentives for lenders to ensure the credit-worthiness of borrowers. However, the language of the bills does not require risk retention by settlement providers unless they also serve as securitizers. This is because settlement providers *buy* but do not *create* a financial asset. As such, the likely interpretation of the Dodd-Frank Act will not mitigate Friction 2 for life settlement securitization.

Life Settlement-Specific Regulatory Proposal 1: Risk Retention by Settlement Providers to Alleviate Frictions 2 and 10. Providers of viatical and life settlements who are not also securitizers should be required to retain some investment risk in their securitized policies. This reform is necessary for the same reason securitizers should retain some risk: Aligning the interests of those with power to represent an investment’s value with the interests of the eventual investors.²³⁰ Note, however, that the new law calls for risk retention by lenders, who again, correspond to insureds in life settlement transactions. However, requiring insureds to retain risk would be inappropriate because financial incentives that take effect after their deaths are unlikely to influence their behavior. Moreover, insureds’ interest in living longer is always at odds with investors’ interests in collecting benefits, as discussed under Friction 9 above.

Risk retention by settlement providers would, conversely, help resolve Friction 2 by incentivizing providers to conduct thorough diligence on insureds and ensure that their settlements are good bets. The reform also aims to reduce Friction 10 between investors and insured’s survivors by encouraging settlement providers to gather as much potentially useful information as possible from the insured so that, in any eventuating litigation, investors will depend as little as possible on the insured’s survivors for assistance.

226. See *supra* text accompanying notes 160, 170, 177-179.

227. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 946, 124 Stat. 1376 (2010).

228. *Id.* § 941(b).

229. *Id.*

230. Others have made similar suggestions. See *Securitization Hearings*, *supra* note 17, at 20 (statement of Daniel Curry, President, DBRS Inc.).

B. Investor Protection Through Credit Rating Improvements

Credit ratings exist to inform investors of the magnitude of risk in their investments. To aid in that mission and to give investors a clearer understanding about the reliability of ratings, the Dodd-Frank Act calls for regulation of CRAs to improve their operations and increase transparency. The law calls for a system of internal controls at each CRA to ensure the integrity of its ratings²³¹ and requires each agency's rating methodologies to be approved by its board.²³² The Act also calls on the SEC to set requirements for public disclosures concerning every rating. The Act provides guidance to the SEC that these disclosures should be easily comparable to the disclosures of other CRAs and should include information regarding data that has informed the rating; underlying assumptions; limitations of the rating and risks that the agency has not examined; the agency's level of uncertainty in the rating; relevant conflicts of interest; historical performance of the rating; and expected probability of default.²³³ While the Act does not prohibit CRAs from being employed by the institutions whose issuances they rate, it does seek to minimize conflicts of interest by requiring agencies to separate their sales and marketing functions from their rating activities.²³⁴

These reforms promise to improve the rating process for all securitizations, increasing the likelihood of accurate ratings and helping investors understand the meaning of the ratings. However, under its new authority from Congress, the SEC will presumably promulgate disclosure requirements with the recent crisis in mind, and the new disclosure requirements will likely focus on the limitations of rating mortgage securitizations. The SEC should ensure, though, that its requirements do not focus too exclusively on those limitations, allowing risks specific to life settlement and other securitizations to go unreported. The SEC should issue tailored CRA disclosure requirements relating to the special limitations on the ratings of life settlement-backed securities.

Life Settlement-Specific Regulatory Proposal 2: Special CRA Disclosures to Alleviate Frictions 7 and 9. To promote transparency and discourage over-reliance on ratings (Friction 7), I propose three disclosures that CRAs should make to investors relating to special attributes of life settlement securitizations. CRAs should make these disclosures rather than securitizers because CRAs have less financial incentive to downplay negative information and perhaps less bias to prevent assessment of negative factors.

First, CRAs should provide investors with an estimate of life expectancy correlation risks. While disease diversity can mitigate the overall effect of advances in medicine, some correlation risk will always remain. CRAs should fur-

231. Dodd-Frank Wall Street Reform and Consumer Protection Act § 932(a)(2)(B).

232. *Id.* § 932(a)(8).

233. *Id.*

234. *Id.* § 932(a)(4).

ther explain that error in estimating correlation risk could seriously and adversely affect rating accuracy. Second, as Congress envisions, CRAs should be upfront about information that they cannot know. In the life settlement context, this means that CRAs should explain that life expectancy determination is not yet a statistically-reliable science, even when applied to large numbers. CRAs should estimate the penetration of STOLI and other fraud in a policy pool but emphasize that no rating agency can be sure of exact figures.

Finally, CRAs should explain that changes in the prognoses of underlying insureds could affect investment values. This information, moreover, may be unavailable to anyone but the insureds themselves (Friction 9) due to medical privacy laws. While this CRA disclosure would not eliminate the friction between investors and insureds, it would alert investors and reduce the likelihood of market panic when investors do encounter Friction 9. Some may argue that generally framed requirements could adequately solicit all of these disclosures, but to ensure that CRAs do not again hide weaknesses in their ratings—intentionally or not—disclosure requirements should be specific.

C. Direct Protections for Investors

The Dodd-Frank Act includes provisions to increase protections of and disclosures to potentially vulnerable investors. These reforms aim to resolve Friction 3 (between securitizers and third parties, including investors) by enabling investors to investigate sellers more effectively. The reforms also attempt to mitigate Friction 6 (between investors and asset managers) by encouraging asset managers to maintain adequate care for clients' interests.

The Act requires disclosure to investors of the R&Ws that come with asset-backed securities and, importantly, how given R&Ws differ from industry standards.²³⁵ The hope here is to give investors enough information with which to identify riskier securities that come without significant guarantees. The Act calls for CRAs to make this disclosure,²³⁶ though some argue it should come directly from issuers themselves.²³⁷ It also requires securitizers to disclose all the repurchase requests they have fulfilled—that is, every time an asset has been repurchased by its issuer because a representation or warranty to investors had been violated.²³⁸ The intention here is to enable “investors [to] identify asset originators with clear underwriting deficiencies.”²³⁹ However, the ABA Business Law Section argues that this information may not be as meaningful as the total number of repurchase requests received.²⁴⁰

235. *Id.* § 943(1).

236. *Id.*

237. ABA SECTION OF BUS. LAW, *supra* note 220, at 35.

238. Dodd-Frank Wall Street Reform and Consumer Protection Act § 943(2).

239. *Id.*

240. ABA SECTION OF BUS. LAW, *supra* note 220, at 36.

In the interest of increasing investment manager accountability to investors (ameliorating Friction 6), the Dodd-Frank Act calls for a study to determine whether to eliminate the distinction between broker-dealers and investment advisors by imposing on the former fiduciary duties of care long associated with the latter.²⁴¹ If Congress does make such a change, then whenever investors rely on broker-dealers' advice in buying asset-backed securities, the broker-dealers would be liable for any lapse in due care. However, this reform is of limited value: In typical securities transactions, unsophisticated investors (such as pensioners) are already represented by investment advisors with fiduciary duties.²⁴²

Understanding R&Ws, knowing about repurchases resulting from R&W violations, and enjoying fiduciary guarantees of broker-dealer care would benefit any securitization investor to some degree. However, these regulations do nothing to address the special risk faced by investors in life settlement securitizations—that an investor-owned policy would be subordinated to policies with ordinary beneficiaries in insurer insolvency (Friction 8). This risk deserves special regulation.

Life Settlement-Specific Regulatory Proposal 3: Investor Protection in Insurer Insolvency to Alleviate Friction 8. A federal mandate of equal treatment for the two policy types could largely cure the risk of investor subordination to traditional beneficiaries. Again, that risk would be most acute in major recessions characterized by popular anger at Wall Street and investors. And since parts of the Dodd-Frank Act may make Washington bailouts of insurance companies more likely,²⁴³ this reform should also ensure that taxpayer bailout funds go to insurer creditors regardless of their investor or non-investor status.

This reform would benefit investors by making investment values clearer, and it is also fair. If investors have paid premiums like policy-holding insureds, it is inequitable to deprive investors of their rightful return. Moreover, investors will have already helped other insureds by paying them for their policies at sale. All insureds benefit from the increased access to liquidity that these investors provide. Federal law should protect all of these benefits—to insureds *and* investors—in insurer insolvencies.

The strongest argument against this reform is that it is unnecessary: Insurers rarely become insolvent and always pay death claims.²⁴⁴ This reform admittedly guards against a worst-case, but possible, scenario that seems most likely in a major recession. As improbable as such a scenario may be, one of the most important lessons of the late crisis must be that the apparent improbability of a crisis is not a sufficient reason to forgo safeguarding against it.

241. Dodd-Frank Wall Street Reform and Consumer Protection Act § 913.

242. See *supra* note 184 and accompanying text.

243. Jonathan Macey, *Dodd Bill Too Opaque*, POLITICO, Apr. 19, 2010, <http://www.politico.com/news/stories/0410/36037.html>.

244. See *supra* discussion at notes 141-143 and accompanying text.

D. Front-End Consumer and Insurer Protections

Other provisions in the Dodd-Frank Act seek to prevent predatory lending and related exploitation of consumers. These provisions aim to resolve Friction 1 (between lenders and borrowers), which threatens to lead to bad debts. The Act creates, within the Federal Reserve System, a new Bureau of Consumer Financial Protection (BCFP) to oversee and regulate institutions that provide financial services or products to consumers.²⁴⁵

However, the BCFP's role in life settlement securitization is likely to be limited. The law may be interpreted to prevent settlement providers from exploiting insureds, but this has become less common than fraud on life settlement investors.²⁴⁶ The BCFP may alternatively protect investors, but life settlement-backed CDO investors are likely to be large institutional investors rather than consumers. Again, though, since insurers in life settlement securitization fill the role of consumer in mortgage securitization, the important "consumer" protections become the provisions that encourage stable market operation by protecting insurers. The proposals below aim to prevent unnecessary risks from falling on insurers and spreading to the rest of the insurance market through, for example, higher premiums.

Life Settlement-Specific Regulatory Proposal 4: Federal STOLI Ban to Alleviate Frictions 1 and 7. The Dodd-Frank Act contemplates substantial nationalization of insurance regulation.²⁴⁷ For the sake of clarity and transparency, the ultimate package of federal insurance regulation should include a prohibition on STOLI, as so many have advocated at the state level.²⁴⁸ A nationwide STOLI ban would ease Friction 1 by simplifying the law that insurers and applicants must navigate and by reducing ambiguity over whether states that have yet to adopt anti-STOLI laws will respect STOLI contracts. The ban would further save insurers from having to bear the extra costs STOLI creates.²⁴⁹ The reduction in ambiguity also serves to somewhat alleviate Friction 7 because CRAs can issue more reliable ratings when they are more certain of the effects of a potential defect in an underlying asset. Some industry proponents would likely charge, as they have at the state level,²⁵⁰ that a federal STOLI ban, depending on its stringency, may go too far and discourage legitimate life settlements. While regulators should be sensitive to these concerns, preventing the systemic costs of STOLI should remain a regulatory imperative.

Life Settlement-Specific Regulatory Proposal 5: Insurance Application Enhancement to Alleviate Friction 1. Insurance regulators should approve life insur-

245. Dodd-Frank Wall Street Reform and Consumer Protection Act §§ 1001-1100(h).

246. Doherty & Singer, *supra* note 30, at 477 n.76.

247. See Dodd-Frank Wall Street Reform and Consumer Protection Act §§ 501-42.

248. See *supra* Sections I.B-C.

249. See *supra* Section I.B.

250. See *supra* notes 94-95 and accompanying text.

ance application forms that include clear warnings against STOLI and questions to discover it. Those applicants who pay attention to the additions may abandon participation in STOLI schemes or reveal enough information so that insurers can appropriately deny applications. This reform would certainly not prevent all STOLI or all fraud but would, in a small way, increase transparency and clarity for applicants and insurers. It will help to reduce the prevalence of STOLI and resolve Friction 1, to the benefit of insurers and investors alike.

CONCLUSION

Life settlement securitization bears many of the risks and frictions identified as causes of the current financial crisis—as well as potentially dangerous frictions not seen in other types of securitization. A breakdown in this market would destroy significant investment value and could create a sizable disaster for the broader economy. A recently enacted law promises to alleviate some of the latent dangers in life settlement securitization, but this Note has shown that likely interpretations of that law will not adequately address the many species of securitization beyond those that sparked the Great Recession. Regulation must go further and address the nuanced risks of markets like the life settlement trade. Congress and President Obama are rightly focusing their economic reforms on issues that have caused the latest crisis, but government should not limit itself to fighting the last war. Neither should it blindly impose one-size-fits-all reforms. Life settlement securitization exhibits risks that threaten all parties involved and, to a degree, the larger economy. This is a market that deserves sensible regulation to clarify risk and minimize bad incentives.