VIATICAL SETTLEMENTS: GHOULISH INVESTMENTS OR BUSINESS OPPORTUNITIES?

by S. Alan Schlact* and Kurt S. Schulzke"

In the financial world, it is common for investors to buy and sell discounted mortgages, notes, certificates of deposit, accounts receivable, and other instruments of debt. However, a new financial transaction has entered the marketplace shich involves the sale of discounted life insurance policies by terminally ill policyholders to investors. With the spread of AIDS and other terminal illnesses that have high medical costs, most people can not afford the necessary medical care to treat their illness. In fact, many AIDS sufferers are unable to afford even the basics needed to maintain life, such as food and shelter. Life insurance policies that have accrued little or no cash value are useless to them until they die, but they need the money now to prolong their lives and relieve their suffering. Thus, several companies have emerged to offer terminally ill persons cash for their life insurance policies. The company buys the policy at a discount and is named as the beneficiary after the policyholder can verify that he or she is dying. The company then pays the premiums due until the insured dies.

The purpose of this article is to review the rise of this type of transaction, discuss whether the practice constitutes the sale of a security, and point out the tax implications of the sale.

I.

The concept of paying death benefits from a life insurance policy to a live insured began in 1965 to a limited degree. In that year, Farmers New World Life Insurance Co. in Mercer Island,Washington, offered a plan that allowed people to draw on their death benefits for kidney dialysis. Within ten years, the company had expanded the program to include other fatal diseases. Known as accelerated death benefits or living benefits, these payments have

"Associate Professor of Business Law, Kennesaw State College. Marietta, Georgia. "Assistant Professor Accounting, Kennesaw State College, Marietta, Georgia.

now become common and are included as riders in the policies of at least seventy-seven major companies.[1] The total number of companies offering this benefit is probably double this amount.[2] All fifty states now allow the use of these riders by insurance companies; however, not all plans are approved in all states.[3]

Unfortunately for many people with a terminal illness, their policies did not include such a rider. Since their own insurance company would not extend benefits to them before they died, these insureds were forced to seek third parties to purchase their policies and benefits. It is believed that Robert Worley, Jr., a financial planner in Albuquerque, New Mexico, started the first company to purchase life insurance benefits from a living person. In 1988, Worley was listening to a terminally ill caller on a radio talk show lament that he needed the money from his policy now, not after he died. However, the caller complained that his insurance company would not even buy his policy at a 50% discount. Worley subsequently formed Living Benefits, Inc., with the intent of buying life insurance policies at a discount from dying individuals.[4] David Petersen, a New York financial planner, helped arrange the first purchase by Living Benefits on New Years Day, 1989.[5] Living Benefits, Inc. is now the oldest and largest company in this field having purchased $17.3 million worth of policies for $11.4 million as of the end of 1991.[6]

These businesses were originally called living benefits companies. However, confusion soon developed as to whether these companies were part of the insurance industry since several insurance companies were offering living benefits riders on their policies. In early 1990, a financial planner in New York named Richard Bandfield coined the term "viatication" to describe the purchase of a life insurance policy by a third party.[7] Although the word does not exist in the dictionary, it does come from the Latin word for voyage, viaticum, and is defined either as an allowance of money for a journey, or as the Christian Eucharist given to a person in danger of death.® Thus, the

[1] *Accelerated Death Benefits*, LIFE ASSOCIATION NEWS, Feb. 15, 1992, pp.76-83. This article includes an excellent review of the policies that each insurance company offers with accelerated benefits, including: types of policies, age limitations, premiums, events that trigger early payout, percentage of policy paid out, when benefit is paid, states where policy is sold, and more.

[2] Texas alone reported 87 life insurance companies that offered accelerated benefits as of midyear, 1991. *Accelerating death benefits*, AUSTIN (TEXAS) AMERICAN - STATESMAN, Sept. 30,1991.

[3] *Id.*

**New Companies are Forming to Buy Insurance Policies of AIDS Patients*, WALL ST. J., July 31, 1992, at 4C:1.

[5] *Companies get cash for the dying before death*, AUSTIN (TEXAS) AMERICAN-STATESMAN, Oct. 1, 1991. Although the application was submitted on January 1, the policy was not actually paid for until four months later.

[6] *Id.*

[7] *Id.*

* WEBSTER'S NINTH NEW COLLEGIATE DICTIONARY (1987).

purchase of a life insurance policy by a third party from a terminally ill person is now called a viatical settlement.

The viatical settlement industry has mushroomed. In just three years, more than twenty five companies have entered the field and it is estimated that more than $100 million in policies has changed hands.[9] While many terminal illnesses have contributed to this phenomenon, AIDS is undoubtedly the catalyst. Most companies buy the policies for between sixty and eighty percent of the face value depending on the life expectancy of the insured. Usually the companies prefer to buy policies that will pay off within one year, but they will go as long as two years.[10] The risk revolves around the possibility that a miracle cure for AIDS or cancer will be found. As ghoulish as it may seem, the investors' return on capital is directly proportionate to how soon the insured dies.

This last point has caused the most concern. Although the viatical settlement companies argue that they are performing a needed function, several government officials believe that they are taking advantage of a dying person due to a lack of regulation. At this time, nothing prevents a person from buying a life insurance policy from another. An individual has the right to buy insurance on his or her own life and to name anyone as the beneficiary.[11] Thus, the only way to regulate this type of sale would be to change insurance law, but it would be difficult. The problem arises when a company advertises for investors and then brokers or sells them a discounted policy.

II.

On August 19, 1992, the Securities Commissioner of the State of North Dakota issued a cease and desist order against two major viatical settlement companies and several of their officers alleging that they were not registered to sell securities nor were the securities registered.[12] This order is the first to challenge these companies by either a state or the federal government. The outcome of the litigation in North Dakota will have an

[9] *AIDS Patients barter insurance for money to live,* ATLANTA JOURNAL/CONS ill (JTION, August 20, 1992, at Al, A16.

[10] *Id.*

[11] GA. CODE ANN. § 33-24-3 (1983); Georgia's law is typical of most states. An individual has an unlimited insurable interest in his own life, health, and bodily safety and may lawfully take out a policy of insurance on his own life, health, or bodily safety and have the policy made payable to whomsoever he pleases, regardless of whether the beneficiary designated has an insurable interest.

[12] Glenn Pomeroy, the Securities Commissioner, issued the orders under N. D. CENT. CODE § 10-04-05 et seq., alleging that life Partners, Inc. and National Insurance Marketing. Inc. were selling unregistered securities and that they were not registered to sell securities. One of the companies has responded by suing Pomeroy in federal court.

impact on whether other states or even the federal government will require registration of viatical settlements as a security.[13]

Although the Uniform Securities Act has been adopted by approximately thirty states, each state has altered the Act to fit its needs.[14] The remaining states have statutes that are similar in scope. The cornerstone of any securities regulation includes the registration of the security and the individuals that sell it. The problem arises in determining what exactly is a security. Such is the case with viatical settlements.

All securities for sale must be registered with the Securities and Exchange Commission and the state where they is issued unless the security or the transaction is exempt.[15] The Act defines "sale" or "sell" as including every contract of sale or disposition of a security, or interest in a security, for value.[16] Thus, the question to be answered in North Dakota and eventually elsewhere is: Whether the sale by a company of an existing life insurance policy from the insured to an investor constitutes the sale of a security?

State and federal statutes that define a security are similar. Both include a laundry list of examples of what constitute a security.[17] However, the inclusion of "investment contract" within the definition has led courts to utilize a broad definition of what constitutes a security.[18] An investment contract exists whenever an individual: 1) invests money, 2) in a common enterprise, with 3) an expectation of profits, 4) to come from the efforts of others.[19] If all of these conditions are met, any investment arrangement or agreement will be considered a security. This determination is a question of law for the court to decide.[20]

Viatical settlements thus appear to be securities. The first and third elements of the definition are easy to meet since the insurance policies are purchased for cash at a discount, thus providing a profit for the investor. That is the very reason for the explosive growth in this industry. The fourth element is also easy to find since viatical settlement companies require nothing

° Mr. Pomeroy is also the past director of the North American Securities Administrators Association and is currently a spokesman for the association.

[14] Robert Prentice, LAW Of Business Organizations And Securities Regulation 480 (1987).

[13] It is unlawful for any person to sell any security in interstate commerce, or through the mails, or to deliver a security by such means after sale, unless a registration statement is in effect as to such security. 15 U.S.C. § *lit* (a). *See also* 69 AM. JUR. 2D *Securities Regulation-State* for a discussion of state requirements.

[16] Section 2(1) of the Securities Act of 1933. For a good discussion of "sale of a security", *see* 69 AM. JUR. 2D *Securities Regulation-Federal* § 16-73.

"Id.

" SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943).

[19] The leading case is still, SEC v. WJ. Howey Co., 328 U.S 293 (1946). Although Howey originally said that profits must come solely from the efforts of others, later decisions have modified this view. See SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476 (11th Cir.)

[20] *Id.* See also, U.S. v. Carman, 577 F.2d 556 (9th Cir. 1978).

of their investors other than the investment of money. The companies find the individuals willing to sell their policies, and they do the investigations necessary to determine the life expectancy of such persons.[21] The only element that may be difficult to prove is a common enterprise.

Courts have been unable to reach a consensus on what constitutes a common enterprise. All courts appear to have accepted the idea of "horizontal commonality." This idea focuses on the relationship between an individual investor and a pool of other investors. It requires that these investors be "joint participants in the same investment enterprise," and that the success or failure of the other investments have a direct impact on the profitability of the plaintiff investor's account.[22] Many of the companies do this by pooling policies and selling them to limited partners.[23] Others sell individual policies to individual investors, either for a fee or at a premium.[24] While this method may be seen as a common enterprise under horizontal commonality, it would definitely be a security under "vertical commonality."

Vertical commonality relies on the relationship of the investor and promoter in seeking profits. Rather than require a connection between investors, this view requires that the fortunes of the investor and promoter be tied together. Not all courts have accepted this view of a common enterprise. However, in those courts that do accept this notion, a common enterprise would exist where viatical settlement companies receive their compensation from the payment of benefits when the insured dies.

It should be clear from the above discussion that a sale of a life insurance policy to or through a company that procures investors for such purpose is a security under the Howey definition. It should be noted, however, that courts have been willing to look at other factors in determining if regulation is necessary. Since these investments involve so much emotion, it is likely that a court would be swayed to find that a security exists.

[21] Many of the companies place ads in gay publications, and Accelerated Benefits recently ran its first ad in New York Magazine seeking insureds willing to sell. On the other side, these companies are sending information packages to prospective investors that border on the obscene. National Insurance Marketing includes a letter that says, "Please review this package in its entirety and call me if you are ready to make some BIG BUCKS!" Other companies include medical case histories of the policyholder with a list of symptoms and illnesses. The package also includes a statement regarding the safety of the investment, "As it stands today, there is virtually no hope for current AIDS patients." Life Partners, Inc., Waco, Texas.

[22] Milnavik v. MS. Commodities, Inc., 457 F.2d 274, 277 (7th Cir. 1972), *cited in* Silverstein v. Merrill Lynch, 618 F.Supp 436 (S.D.N.Y. 1985).

[23] Affirmative Lifestyles, Inc. of San Antonio, Texas is a good example.

[24] Living Benefits, Inc. of Albuquerque, New Mexico is a good example.

III.

Another area of concern for those individuals who are selling their policies is the tax considerations. Terminally ill policy-holders needing or wanting immediate cash may justifiably not care about the tax treatment of the proceeds. Nevertheless, it can be a major issue and should be carefully examined, if for no other reason than for the benefit of the heirs. Unfortunately, viatical settlements present questions not yet fully addressed by Congress or the Internal Revenue Service. Major differences in tax treatment may result depending on who cashes out the policy and why. The following discussion examines just how viatical settlements may fit into existing tax law.

Generally, the proceeds of life insurance policies are exempt from income taxation; however, this rule applies only where the proceeds are received by reason of the death of the insured.[23] In practice, this terminology has exempted proceeds paid once death has actually occurred, but not those paid out by reason of impending demise. Also, where the beneficiary has acquired the rights to the death benefit in exchange for valuable consideration, the eventual death benefit proceeds are only excluded up to the value of such consideration plus the amount of premiums paid subsequent to the original acquisition.[26]

U.S. tax law employs an all-inclusive definition of taxable income, meaning that all income, from whatever source, is subject to tax.[27] The only categories of income which are tax exempt are those specifically identified as such by the law. The Code currently excludes from taxable income gains and losses realized on certain *exchanges* of insurance policies[28]; however, no exemption is granted for gains from outright *sales* of rights in life insurance contracts.

Since the law does not specifically exempt such sales, the proceeds therefrom are taxable to the extent that they exceed the seller's tax basis (usually the total amount of premiums paid) in the policy. The excess of proceeds over tax basis is treated as capital gain[29] in the year proceeds are received. The following example illustrates the application of this principle.

T, an individual taxpayer purchased in 1983 an ordinary term life insurance policy with a face value of $500,000. Over a period of 10 years, Ts premiums totalled $10,000. In 1992, after paying the annual premium, T is diagnosed with a terminal medical condition. Ts doctors project that T has

[23]1.R.C. § 101(a)(1) (1992).

" I.R.C. § 101(a)(2) (1992).

[27]1.R.C. § 61 (1992). [a] I.R.C. § 1035(a) (1992).

[25] For the non-dealer life insurance policy-holder, the right to death benefits under the policy constitutes personal-use property fitting the I.R.C. § 1221 (1992) definition of capital assets; therefore, gain or loss on the disposition thereof is capital gain or loss.

24 months to live. In order to pay medical bills and make life a little easier during what he believes will be his last 24 months, T sells for $350,000 the rights to the death benefits under his term life policy to V, a brokerage firm specializing in viatical settlements. Ts 1992 taxable gain would be $340,000 ($350,000 sales price, less the premiums invested of $10,000).[30] Assuming a marginal tax rate of 28 percent, this translates to additional tax of $95,200. This kind of information is not likely to be happily received by a terminal client.

A different tax answer may result where the policy is not sold, per se, but the insurance underwriter pays out a portion of the face value early in accordance with a so-called "living benefit" or "accelerated benefit" rider. In this scenario, whether the proceeds are taxable or not may depend on how the rider is written. The general rule of Sec. 101(a) appears to subject such proceeds to tax; however, if the rider contains language which identifies the proceeds as compensation for injuries or sickness, then the early proceeds may be tax exempt under Code Sec. 104.[31]

Another option is to borrow the needed cash, using the right to the death benefits as collateral. The loan could be structured as a lump-sum term loan requiring the payment of principal and interest at the earlier of a far future date or a specified number of days following the date of death. This would provide security to the lender and exclude the loan proceeds from taxation. The keys to this kind of arrangement include (a) finding a willing lender and (b) structuring the loan so as to qualify as a bona fide debt under "facts and circumstances" scrutiny by the I.R.S.

CONCLUSION

The sale of a life insurance policy to or through a company that procures investors for such purpose is a security and should be registered with the Security and Exchange Commission and any appropriate state agencies. In addition, such sale is the sale of an asset that will result in a taxable profit for the seller.

[50] Alternatively, the I.R.S. could argue that the $10,000 in premiums were actually paid for coverage in prior years and, therefore, the tax basis in such a term life policy should be zero as of the date of sale. In this case, the taxable gain would be $350,000.

[31] I.R.C. § 104(a)(3) (1992) excludes from tax "amounts received through accident or health insurance for personal injuries or sickness. .