[FEATURE] by Sari Gabay-Rafiy

Life Insurance a go go: Life Settlement Market Unsettles Some, but Holds Sure Opportunities for Producers if…

A precise overview and update on this controversial, emerging market sector, one that requires careful counsel when your "baby boomer" clients –inevitably—ask you about payout potential.

Sari Gabay-Rafiy

What started during the AIDS epidemic as viatical settlements has taken a new life of its own in the secondary life insurance market. Powerful publicity, attractive advertising and a stunning number of enterprising capitalists have pushed this new market to a limit of attractiveness not foreseen at its inception. Life settlements and a batch of acronyms accompanying the new field from STOLI's, BOLI's, IOLI's and the rest have taken hold in the field and have often disrupted relations in the life insurance business between carriers, brokers, thinkers, regulators, lawmakers and insureds. The field is here to stay, for sure, but it may be regulated out of its Wild West atmosphere as, one by one, states across American undertake to grapple with the temptation for turning life insurance into high stakes wagering.

As a consequence of the public relations and communications efforts of some providers and brokers, it is inevitable that your good clients or even your friends at cocktail receptions or at the beach club will be asking you "what's this all about, this life settlement opportunity?" We thought it prudent to present a precise overview of the subject, its limitations and its opportunities in the form of a overview written by talented young attorney Sari Gabay-Rafiy. You have come to know Mrs. Gabay Rafiy in these pages before and will appreciate her careful work laying out an introduction to the subject. ***- Ed.***

Traditionally, if a life insurance policy had been purchased years earlier and the insured had outlived the purpose for which the insurance had been procured (i.e. the children were grown, educated and the insured was in retirement seeking to reduce expenses), the insured could surrender the policy to the insurance company for its cash value, or if it were a term policy, let it lapse.

Today, with the growing secondary market for life insurance, a policyholder who no longer needs a life insurance policy can enjoy a substantial cash benefit larger than the cash surrender value of the policy while still living, by "settling" his or her policy. Hence, the term "life settlement."

In a typical life settlement transaction, a life settlement broker negotiates a life settlement contract between the policyholder and a life settlement company. In exchange for purchasing the policy, the life settlement company becomes the new owner and beneficiary of the policy and is responsible for payment of future premiums. Upon death, the death benefit is paid to the life settlement company.[1] Life settlement transactions have become increasingly popular as the secondary market for insurance grows. The concept of settling one's life insurance policy, however, is not new.

This growing trend is derived from viatical settlements which emerged in the late 1980's during the AIDS epidemic. At that time, many terminally ill owners of life insurance policies sold their policies to pay for medical care or other necessities. The insureds, or viators,[2] had a life

expectancy of less than two years. Article 78 of the Insurance Law was enacted in 1994 to regulate the purchase of policies of individuals with a terminal illness. Article 78 requires among other things, (1) licensing of viatical settlement companies and viatical settlement brokers; (2) the Superintendent's approval of viatical settlement agreements prior to use; and (3) certain disclosures and filings.

Viatical settlement transactions and life settlement transactions are essentially the same, with the key distinction being the health of the insureds. In a viatical settlement, the insured is expected to die in less than two years whereas in a life settlement transaction, the insured is expected to live more than two years.

Current New York Insurance Law

New York Insurance Laws require viatical settlement brokers and viatical settlement companies to be licensed and the New York State Insurance Department regulates viatical settlement transactions. However, as it stands, life settlement providers and life settlement brokers in New York are not required to be licensed and are not regulated by the Department.[3] *See, e.g., Office of General Counsel Opinion, March 17, 2004* (opining that no license from the Department is required of a company that purchases "life settlements" from New York residents). For example, in a March 1, 2002 Office of General Counsel Opinion, the Department stated that life settlements, or the sale of a life insurance policy by an insured who has a life expectancy in excess of two years, are permitted in New York. The Department explained that if any policy purchased from a New York resident is from a viator, (see New York Insurance Law § 7801(b)), the purchaser would have to be licensed as a viatical settlement company and the producer of such policy would have to be licensed as a viatical settlement broker.[4]

As the Department has pointed out in its Top Ten Questions About Life Insurance, without regulation of the life settlement industry in New York, "[t]here are no requirements for disclosure." Consequently, the insured may not be aware of potential tax implications that may arise from the sale of the policy or the benefits of keeping the original policy or the relationship between the life settlement broker and the life settlement company. Moreover, when an insured has a complaint in this area, the Department "can only provide limited assistance." There is also the overarching concern that "[l]ife settlement companies may encourage people to purchase new insurance for the sole purpose of entering into a life settlement."[5] As discussed more fully below, this would run afoul of New York's insurable interest requirements.

The Insurable Interest Rule

New York Insurance Law §3205(b)(2) prohibits the procurement of a contract of insurance on another person "unless the benefits under such contract are payable to the person insured or his personal representatives, or to a person having, at the time when such contract is made, an insurable interest in the person insured." Section 3205 of the Insurance Law defines the term "insurable interest" 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.

The "insurable interest rule" was designed to prevent the issuance of "wager" life insurance policies. As early as 1881, the United States Supreme Court in *Warnock v. Davis*, recognized the concept of an insurable interest. In that case, the day the insured's life insurance policy was issued, he assigned his interest to an association that had no insurable interest in him. The Court found the assignment invalid because the association lacked an insurable interest in his life.[6]

In 1911, in *Grigsby v. Russell*, the U.S. Supreme Court discussed the rationale for the insurable interest rule:

> A contract of insurance upon a life in which the [policy owner] has no interest is a pure wager that gives the [policy owner] a sinister counter interest in having the life come to an end. And although that counter interest always exists, …the chance that in some cases it may prove a sufficient motive for crime is greatly enhanced if the whole world of the unscrupulous are free to bet on what life they choose.7

The "insurable interest rule" was designed to prevent the issuance of "wager" life insurance policies. As early as 1881, the United States Supreme Court in *Warnock v. Davis*, recognized the concept of an insurable interest.

More recently, in 2008, in *Life Product Clearing LLC v. Angel*, 530 F. Supp 2d 646 (S.D.N.Y. Jan. 28, 2008), the Southern District of New York recognized, "[t]he law has long shown a disdain for 'wager' insurance policies-life insurance contracts that are a mere wager, by which the party taking the policy is directly interested in the early death of the assured."[8] In that case, the purchaser of a beneficial interest in a trust sought a declaration that the transfer of a life insurance policy was valid and that the insured's estate had no interest in the proceeds of the life insurance policy. More specifically, a 77 year old retired butcher established a trust with himself as the beneficiary. The same day he applied for a $10 million life insurance policy designating the trustee as the sole beneficiary.[9] The premium for the first year was $572,000, an amount he could not afford. Only six days

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after the policy was issued, he sold his interest in the trust and the right to the insurance proceeds to Life Product Clearing LLC ("LPC") for $300,000. He died five days after receiving payment from LPC.[10] The insurance company subsequently paid the face value of the policy with interest ($10,712,32.77) to the trust. The insured's estate contended that this was an impermissible wager policy because LPC was a stranger who gambled $300,000 on the early death of the insured. Because there were material issues of fact as to the insured's intent, the case could not be disposed of on summary judgment grounds.

Nonetheless, the court recognized that today, it is permissible under Section 3205(b) of the Insurance Law to assign a life insurance policy even to one who does not have an insurable interest, so long as the policyholder procured the policy on his or her own initiative and in good faith. Determining intent may involve several factors, such as whether the policyholder could actually afford the premiums and whether the policy was procured with the intent of assigning it immediately.[11]

"Life Settlement Broker" is defined as "a person who, for compensation, solicits, negotiates, or offers to negotiate a life settlement contract."[14] Notably, the Bill specifically excludes from the definition of life settlement brokers, professionals whose role would likely be advisory only.

Introduction of Senate Bill S7356

With the introduction of Senate Bill S7356 on April 2, 2008 (Assembly Bill A10401, March 27, 2008) (the "Life Settlements Act" or the "Bill"), New York regulators may be upping the ante. Although the legislative session has ended and the bill would have to be reintroduced in the next session, life settlement brokers and life settlement companies in New York may be facing considerable changes.

Article 78 of the Insurance Law would be titled "Life Settlements" and would be known as "The Life Settlements Act." It would provide for licensing of life settlement brokers and companies, registration of settled policy investors, approval of life settlement contract forms, reporting requirements, privacy and confidentiality, and mandatory disclosures. It would impose penalties for violations. Below is an overview of significant sections of the Bill.

Licensing of Life Settlement Brokers[12]

The proposed Life Settlements Act defines "business of life settlements" as "any activity involved in, but not limited to, the offering solicitation, negotiation, procurement, effectuation, purchasing, investing, financing, monitoring, tracking, underwriting, selling, transferring, assigning, pledging, or hypothecating of life settlement contracts or settlement policies."[13]

"Life Settlement Broker" is defined as "a person who, for compensation, solicits, negotiates, or offers to negotiate a life settlement contract."[14] Notably, the Bill specifically excludes from the definition of life settlement brokers, professionals whose role would likely be advisory only. These persons include licensed attorneys, certified public accountants, and certain financial planners, who do not advertise as being in the life settlement business and who are paid regardless of whether a life settlement contract is effectuated.

In many respects, the proposed licensing requirements for life settlement brokers tracks the current requirements for insurance producers. The proposed life settlement licensee will have to pass an examination after completing a course of at least forty hours as well as an application as prescribed by the Superintendent.[15] Each business entity will have to designate a sub-licensee as a designated responsible person for the business entity's compliance with the insurance laws and regulations.[16]

Certain exceptions may apply for currently licensed individuals. For instance, an insurance producer with a life line of authority licensed in New York for at least one year will not be required to take the pre-licensing course or examination.[17] On the other hand, other obstacles such as a prior felony conviction may render it more difficult for certain individuals to obtain a life settlement broker's license.[18]

The Bill gives the Superintendent additional powers with respect to licensing. He may refuse to renew, may revoke, or may suspend a life settlement broker's license for violating any insurance laws or regulations, providing materially incorrect or misleading information, or demonstrating untrustworthiness, among other conditions.[19] The Bill's proposed licensing requirements and conditions of competence and trustworthiness, and the Superintendent's powers with respect to such licenses are consistent with the provisions applicable to other insurance producers and adjusters.[20]

Registration of Investors and Intermediaries

The Bill also has ramifications for investors and life settlement intermediaries. The investors and intermediaries, although generally non-licensees, will be required to register with the Department and will be subject to penalties for failing to comply with applicable requirements. Registration requires completing an application and providing certain information including: all other states in which the registrant intends to do business, the identities of officers directly responsible for such business, and stockholders with a controlling interest in the proposed registrant. In addition to paying a fee, the applicant may have to submit fingerprints.[21] The Superintendent will determine whether that person is deemed "to be trustworthy and competent."

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Notably, New York would be the first state to require investors in life settlements to be registered with the state's Insurance Department.[22] Thus, once a policy is sold, it can be re-sold only to a registered investor. If enacted in New York, it is likely that other states will follow New York's legislation as New York was also the first state to require licensing of reinsurance intermediaries, which has since been enacted throughout the United States.

This Section is not to be taken lightly. If the Superintendent determines that someone acted as life settlement investor or intermediary without proper registration, he may impose a civil penalty of up to $10,000 for each transaction and may require the investor or intermediary to compensate the insured.[23]

Approval of Forms and Reporting[24]

The Bill also requires that life settlement contract forms be approved by the Superintendent prior to use.[25] The Superintendent may not approve a contract if it is found "unreasonable, contrary to law or to the interests of the public, or otherwise misleading or unfair." The Superintendent may also withdraw previously given approval if the use of the form is "contrary to the requirements applicable to the form", "prejudicial to the interests of the policyholders or members" or if it contains provisions that are "unjust, unfair or inequitable."

The Department has long engaged in approving policy forms. Article 78 requires similar approval for viatical settlement contracts. Likewise, Section 3210 requires approval of life, accident and health, credit unemployment and annuity policy forms.

Additionally, every licensed life settlement provider must file an annual statement with the Superintendent showing its condition at the end of the previous year. The annual statement must include, among other things, the total number, aggregate face amount and life settlement proceeds of policies settled during the prior year. Willful failure to timely comply with this requirement can result in a fine of up to $1000 per day for any delay.[26]

Privacy and Confidentiality[27]

A significant provision of the Bill is its privacy requirements. Specifically, no life settlement provider, broker, investor, or any person who learns of the insured's or owner's identity in connection with a proposed or actual life settlement contract "shall disclose the identity of the insured or owner" unless such disclosure is made to a licensed life settlement provider or broker or registered life settlement investor, "as reasonably necessary for the purpose of effectuating a life settlement contract and upon the written consent of the "insured or owner." Life settlement providers, brokers, settled policy investors and intermediaries must require their authorized representatives to agree in writing to adhere to the Bill's privacy provisions. Moreover, medical information will be subject to the provisions of the Public Health Law and other state and federal laws governing the confidentiality of medical information.

At the time the viatical settlement legislation was enacted in 1993, privacy concerns were likely not as great as they are today with the advent and pervasiveness of the internet. The federal Health Insurance Portability and Accountability Act (HIPAA) was not enacted until 1996. Privacy has become a great concern as it is easier to transmit and share personal information. Additionally, crimes based upon acquiring personal information such as identity theft have risen. Accordingly, the proposed Life Settlements Act has addressed privacy concerns for today's current climate.

Mandatory Disclosures[28]

The Bill provides for transparency by requiring over 21 types of disclosures by the life settlement company to the policyholder. These include, among others, revealing the amount of the current death benefit payable to the life settlement provider, the dollar amount of each life settlement provider's final offer, the identity of any person receiving compensation in connection with the life settlement contract (including the broker) and the amount and terms of such compensation. Other disclosures include possible alternative to life settlements, potential tax consequences that may result from the receipt of proceeds of a life settlement contract, and the relinquishment of certain rights or benefits by selling the policy during one's life.

Additionally, a life settlement company must disclose that the owner has a right to rescind a life settlement within 15 calendar days of receipt of the life settlement proceeds and that the insured may be contacted (and the frequency of contact) for the purpose of determining the insured's health status. There is even a catch-all for "any other disclosure as may be prescribed by the Superintendent."

These changes are significant because the policyholder may not realize the value of the policy being sold. And, it requires brokers to act in the best interest of the insureds when negotiating the transaction by having to apprise the policyholder of any and all bids on the policy.

Time Limitations[29]

Life settlement companies are prohibited from entering into a contract to buy an insured's policy within the first two years after it is issued. There are certain exceptions which may be applicable where the insured's spouse dies, the insured gets divorced, or the insured is bankrupt or insolvent. This restriction would prevent the purchase of life insurance policies for the purpose of immediately selling them to a life settlement company.

The two year prohibition on a life settlement proposed by the Life Settlements Act is more flexible for life settlements than the five year prohibition proposed by the National Association of Insurance Commissioners' ("NAIC") Model Viatical Settlements Act (the "Model Act"). New York and most other states have a two year incontestability clause which basically requires the insurer to pay life insurance benefits even if there were misrepresentations in the application for insurance. Generally, a life settlement company would only purchase the policy after the two year incontestability period had passed.

Compliance with Advertising[30]

The New York Insurance Department currently has stringent guidelines with respect to advertisements for life accident agents. Under the proposed Life Settlements Act, life settlement advertising would become subject to these guidelines.

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For instance, no person shall "(1)directly or indirectly market, advertise, solicit or otherwise promote the purchase of a policy for the primary purpose of . . . the settlement of the policy." There are also restrictions on using in marketing or solicitation the terms "free," "no cost" or words of similar import.

Whereas the Insurance Department does not currently regulate life settlement advertisements, it regulates advertisements that relate to viatical settlements as those are within its authority. For example, in an Office of General Counsel Opinion, an inquirer sought approval of a life settlement advertisement. Because the so-called life settlement advertisement had characteristics of a viatical settlement, the Office of General Counsel opined that it did not comply with requirements under the New York Insurance Law and regulations. Interestingly, the advertisement stated, in part:

> GET CASH FOR YOUR LIFE INSURANCE POLICY... Empower Yourself To: Fund a lifelong dream. Take a long awaited vacation. Make a charitable gift contribution. Purchase a luxury item that was never affordable to you before. Enjoy the money with friends and family. Purchase a life product that better suits your financial needs. You May Qualify If You Are: Over the Age of 70 or living with an illness.

Since someone "living with an illness" could qualify, the Department opined that the laws and regulations applying to viatical settlements applied and the proposed advertisement was not permissible.[31]

Civil and Criminal Penalties[32]

The Bill prohibits a "fraudulent life settlements" and adds a new section to the Penal Law to create new crimes of life settlement fraud. In addition, to any criminal liability, Section 403 of the Insurance law which provides for civil penalties of up to $5,000, would be amended to include life settlement fraud. Moreover, the newly enacted portion of the Insurance Law, would provide that should the Superintendent determine that someone acted as a life settlement broker or life settlement company without a license the Superintendent may impose a civil penalty of up to $10,000 for each policy and may require the life settlement broker or company to compensate the insured.

Is This Over-Regulation?

New York's Life Settlements Act, overall, is consistent with the regulations applicable to viatical settlement companies and viatical settlement brokers. Life settlement brokers and companies would be subject to the same licensing and advertising requirements. While there are heightened privacy and disclosure requirements under the Bill, Article 78 was enacted to protect terminally ill policy holders who were expected to die within two years. The Life Settlements Act is designed to protect healthy senior citizens who may live for many years after settlement of their policies and therefore may need greater consumer protections.

New York's proposed Bill may be more lenient than the NAIC's Model Act. For instance, under the Model Act, the sale of a life insurance policy would be prohibited within five years of inception.[33] In New York, however, only a two year limitation would apply. If implemented, time will tell whether two years is sufficient to curb abuses of the insurance interest requirement.

The Bill will most likely be reintroduced in the Senate and Assembly.[34] If enacted, the Bill will be effective 180 days after enactment though the disclosure requirements would be effective immediately. As of now, without Department oversight, bets on death in the secondary market for insurance are not off the table. Until regulators up the ante, players place your bets. [IA]

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This article is for informational purposes only and is not intended to give legal advice. For more information, please contact Gabay-Rafiy & Bowler LLP, gabay@gabaybowler.com or 212.941.5025.

Notes

1 For more information on how life insurance settlement transactions can be used to enhance one's estate, see Barry Kaye, You Buy You Die, It Pays! (FHA Press 2006).
2 The term "viator", stems from Latin "viaticum," and translates to "provisions for a journey."
3 Although New York has not yet implemented regulations governing life settlements, at least twenty five other states regulate both viatical settlements and life settlements. See http://www.lisassociation.org/vlsaamembers/legislative_maps/images/Reg-of-viatical-and-life-se.jpgLISA.
4 See also OGC Op. Feb. 21, 2002 (applying same analysis and stating that a license is only required for viatical settlement companies and brokers).
5 http://www.ins.state.ny.us/que_top10/que_life_ set.htm
6 Id. at 779-80.
7 222 U.S. 149, 154-55 (1911).
8 Quoting Warnock v. Davis, 104 U.S. 775, 779 (1881).
9 See 530 F.Supp2d at 647.
10 See id.
11 Life Product Clearing LLC v. Angel, 530 F. Supp.2d 646 (S.D.N.Y. 2008).
12 See Senate Bill S7356 §3(1).
13 Id. §12.
14 Id. §2.
15 Id. §8.
16 Id.
17 Id. §7.
18 Id. §3.
19 Id. §4.
20 See New York Insurance Law §2101(a).
21 See New York Insurance Law §1102(e)(C)(2).
22 Investment new, April 28, 2008 http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20080428/REG/196230213/1009/TOC
23 Senate Bill S7356 §12.
24 See Senate Bill S7356 §12.
25 Id.
26 Id.
27 Id.
28 See Senate Bill S7356 §12.
29 Id. at §8.
30 Id. at §12.
31 (OCG Op. November 6, 2004)
32 Senate Bill S7356 §§12,13, and 21.
33 NAIC Press Release http://www.naic.org/Releases/2007_docs/viatical_settlements_model.htm
34 In 2006, the Legislature introduced various versions of this Bill (A 8785-c, S 8166, S 8463). The Bill did not make it out of Committee in either the Senate or the Assembly.