1998

Death for Sale: A Call to Regulate the Viatical Settlement Industry

Joy D. Kosiewicz

Follow this and additional works at: https://scholarlycommons.law.case.edu/caselrev

Part of the Law Commons

Recommended Citation
Available at: https://scholarlycommons.law.case.edu/caselrev/vol48/iss3/8

This Comments is brought to you for free and open access by the Student Journals at Case Western Reserve University School of Law Scholarly Commons. It has been accepted for inclusion in Case Western Reserve Law Review by an authorized administrator of Case Western Reserve University School of Law Scholarly Commons.
COMMENT

DEATH FOR SALE: A CALL TO REGULATE THE VIATICAL SETTLEMENT INDUSTRY

INTRODUCTION

Viatical companies gamble on people’s lives. They purchase the life insurance policy of a terminally or chronically ill patient, pay the premiums, and wait. In the meantime, the patient may use the cash proceeds from the transaction in any way. When the person dies, the viatical company receives the benefits of the policy. The sooner the patient dies the greater the viatical company’s profit; the gamble is that the person will die before a date predicted by the viatical company.

The viatical settlement industry has been prospering for nearly 10 years. By 1996, life insurance policies totaling approximately $500 million were sold in viatical settlements. In the United States alone, the projected figure for 2000 is $4 billion. Viatical settlements are available in all 50 states. The industry was launched in 1989 with an eye toward AIDS patients and today is

---

1. The viatical settlement industry began with three companies in 1989. See Viatical Association of America (copy on file with the author) [hereinafter VAA Newsletter] (some of this information and additional updates can be located at <http://www.caids.com/viatical/>).
2. Rod Schrader, Viaticals Link Terminal Patients to Investors, PUGET BUS. J., Sept. 26, 1997, at 18B. An actuarial and consulting firm in Chicago, Milliman & Robertson, Inc., estimated the 1995 number to be more than $322 million and the 2004 estimate to be double. See VAA Newsletter, supra note 1.
3. Schrader, supra note 2, at 18B.
Looking to bargain with other terminally and chronically ill patients and the elderly. Beginning with three companies in 1989, the viatical industry has expanded to between 40 and 50 companies. A secondary market has evolved in which anyone can invest by contacting his or her local broker. Still, the industry remains virtually unregulated, as no national regulation exists and less than 20 states require licensing of viatical settlement companies.

The viatical settlement industry historically has been immune from such regulation. Although the National Association of Insurance Commissioners (NAIC) has promulgated both the Viatical Settlements Model Act (Model Act) and the Viatical Settlements Model Regulation (Model Regulation) and some states have drafted similar viatical regulations, “[m]any states have not yet codified viatical regulations... leaving much of the terminally ill population without protection from potential abuses by viatical settlement purchasers.” Rather, the industry has flourished through privileges, such as lack of restrictions and preferential income tax treatment. The Model Act and the Model Regulation are a good start, but are only guidelines and have only been adopted by a minority of states. The Securities Exchange Commission (SEC) has attempted to assume regulatory responsibilities for the secondary market by treating the investments as securities, but the Court of

---


7. See VAA Newsletter, supra note 1.


11. Schultz, supra note 7, at 110.

---
Appeals for the District of Columbia has held that securities law does not apply and therefore this market remains unregulated.\textsuperscript{12}

This Comment will address the need for regulation in the viatical settlement industry. Regulation is necessary to curb the potential for abuse stemming from the unbalanced relationship between the viatical company and the viator—the patient selling his or her life insurance policy. On one side of the transaction is a large company with numerous resources, lots of money, and enormous bargaining power. On the other side is a terminally or chronically ill patient or elderly person with little money, big expenses, and few resources. Even if viatical settlements are a positive alternative for the terminally and chronically ill, regulation is necessary to ensure that the transaction is fair, just as transactions in other industries are regulated to prevent coercion and unconscionable conduct, because the viatical industry engages in activities that go beyond existing laws protecting buyers and sellers such as contract law, securities law, and the Uniform Commercial Code.\textsuperscript{13}

This Comment will address the issue of regulation by considering how existing regulations were formulated and how the industry has evolved since their creation. There is a significant potential for abuse in the industry and its secondary markets, yet existing regulations have not been widely adopted, and do not address issues that have arisen with the growth and broadening of the industry. This Comment therefore proposes that legislatures regulate both the primary and secondary markets of the viatical industry.

I. BACKGROUND

On the surface, a viatical settlement is a simple transaction between two people in which one person, the viator, sells his or her property for cash to the buyer, the viatical company.\textsuperscript{14} The essential components of the bargain are a life insurance policy, a significant sum of money, and the death of the insured. One perception of the deal is that a big company is taking advantage of a desperate consumer. On the other hand, the consumer is getting much needed money to live the rest of his or her life in dignity.

\begin{enumerate}
\item See Pardo II, 87 F.3d 536; see also infra notes 167-70 (providing a more detailed treatment of Pardo II).
\item See Pardo I, 898 F. Supp. at 17 n.2 ("Viatical settlements stretch existing laws that protect the interests of buyers and sellers.").
\item See infra notes 55-62 and accompanying text for further discussion of the viatical settlement process.
\end{enumerate}
and happiness without financial concerns. While there is probably a little bit of both going on, deeper analysis reveals that these settlements involve much more than the ordinary buyer—seller relationship. The potential for abuse and the amount of risk involved is high, and the buyer and seller are not the only parties affected by the transaction. Based upon these considerations, regulation of the viatical settlement industry is in everyone’s best interest.

A. The Parties

The buyer is a large company which is part of an even larger industry. The viatical settlement industry emerged as a result of the AIDS crisis in the late 1980s and has grown rapidly, expanding its reach to other terminally and chronically ill patients. The industry projects the elderly population to be the next generation of viators.

Viatical companies provide a service to people desperately in need of money. Viators may use the cash proceeds received from their life insurance policy to pay medical bills and do things for themselves and their families that they could not do before. Viatical companies, however, do not have complete advantage over viators. They also are taking a big risk in these transactions and their profits are not certain. It is difficult to predict life expectancy, and with new treatments being developed every day, predictions become even less certain. If the viator lives much longer than expected, the viatical company will take a loss.

The seller is usually a consumer who is faced with death and is in a weakened physical, mental, and financial condition. Few consumers know what a viatical settlement is or how it works. Potential viators do not have the time or resources to thoroughly research their options and a viatical settlement may bring about unexpected consequences as a result. For example, Congress has made viatical settlements more attractive by giving them prefer-

---

15. See Pardo 1, 898 F. Supp. at 17; see also supra note 4 and accompanying text. The notion of viatical settlements has been around for quite a long time. See Malcolm E. Osborn, Rapidly Developing Law on Viatical Settlements, 31 WAKE FOREST L. REV. 471, 471 (1996).
16. See Dunlap, supra note 5, at C1.
17. See id.
18. See Schultz, supra note 7, at 104-05.
However, in order to get preferential treatment, the viatical company must satisfy several requirements. It is not likely that a viator will know these requirements exist, or whether a viatical company has complied with them. In addition, because of the large cash payment received, the viator may lose benefits from state- and federal-based entitlement programs. Viators may not be prepared to lose these benefits and may not be able to afford to lose them despite the cash proceeds from the sale.

The impacts of viatical settlements felt by third parties highlight the need for regulation of the industry. The sale of the viator’s life insurance policy leaves the viatical company the sole beneficiary, cutting off the original beneficiaries. Full disclosure of the consequences of entering a viatical settlement would prevent this as an unintended consequence. It may also prevent the original beneficiaries from taking action against the viator or the viatical company. Regulation, particularly licensing requirements, will promote high standards within the industry and prevent abuse within the industry. For this reason, regulation may be a benefit to viatical companies as well.

Several organizations have formed to represent the views of the various participants in viatical settlements. To assist viators, the National Association of People with AIDS (NAPWA) helps patients get their money when they need it and can use it. NAPWA also wants to ensure that patients are getting fair deals in the process. The Viatical Association of America attempts to satisfy the needs and interests of both viators and viatical companies.

21. See infra notes 69-72 and accompanying text for a more detailed discussion of Congress’ treatment of viatical settlements under the tax code.
22. See infra note 71 and accompanying text.
23. See VAA Newsletter, supra note 1.
25. See id. It is possible to sell only part of the ownership of a life insurance policy. See VAA Newsletter, supra note 1. The availability of this option depends on the viatical company.
26. See VAA Newsletter, supra note 1.
27. See id.; see also Spring 1994 Report, supra note 20, at 361.
29. See VAA Newsletter, supra note 1. A self-regulating agency such as the VAA is one possible means for regulation of the industry. The problem is in achieving participation from all viatical companies. Currently only a few companies associated with the viatical industry are members of the VAA. See id.
Finally, people who are not involved in or affected by the viatical industry also assert their views because of an underlying moral debate regarding viatical settlements. Some question the ethics of an industry in which companies profit from the death of the people with whom they deal. The fact that a viatical company’s profit is increasingly larger the sooner the viator dies makes people even more uncomfortable. For these reasons, many people would like to see the industry heavily regulated or even completely abolished.

B. Current Attempts to Regulate

As the viatical industry has continued to grow, states have attempted to find ways to regulate viatical settlements. States have found it difficult to bring viatical settlements under existing laws which protect buyers and sellers. Thus, they have begun passing viatical settlement legislation codified in the insurance sections of their respective codes.

The first national attempt to regulate the industry began with the NAIC drafting the Model Act and the Model Regulation. When the Model Act and the Model Regulation were promulgated, the NAIC had AIDS and other terminally ill patients in mind. Among the first people contacted by the NAIC for comments on viatical settlements was Bill Freeman, the Executive Director of NAPWA. NAPWA advocated viatical settlements as a positive means for AIDS patients to live the rest of their lives in dignity. In a survey, NAPWA found that the overwhelming needs of AIDS patients were financial assistance and access to medicine and health care. The money obtained through a viatical settlement allows AIDS patients to meet these needs.

NAPWA endorsed some regulation of the industry but warned against too much restriction. The association agrees that full dis-

---

30. See Schultz, supra note 7, at 104.
32. See id.
33. See id.
34. See Spring 1994 Report, supra note 20, at 360.
35. See id.
36. See Winter 1992 Report, supra note 28, at 786-87 (speaking specifically for people terminally ill due to HIV and AIDS, but acknowledging that other terminally ill people may have similar concerns and therefore his comments would also apply to them).
37. See id.
38. See id.
closure of the consequences of the transaction should be required
and that viatical companies should be subject to background checks
and registration requirements. The association, however, fears too
many restrictions may be a disincentive for viatical companies to
conduct business. Thus, NAPWA discourages burdensome registra-
tion processes and mandated minimum payouts. It feels having too
much regulation will hinder viators from having a broad range of
choices and receiving the largest possible sum as quickly as possible.

Viatical settlement companies were also contacted for com-
ments. In general, viatical settlement companies are unopposed
to some regulation but advocate limited restrictions. For exam-
ple, viatical companies generally do not oppose disclosure re-
quirements but do oppose mandatory minimum payouts. The viatical
companies argue that competition and the free market provide the
most effective and efficient means for achieving fair transactions.
If abuse does occur, remedy may be sought under already existing
laws for breach of contract. Further, Mr. Willson, of the Nation-
al Viatical Association, stated that “the viatical industry was in the
process of becoming a self-regulatory industry.”

In response, Commissioner David Lyons (Iowa), of the Viatical
Settlement Working Group, stated he was not surprised to see
individuals zealously protecting the viatical industry, which to that
point had not been subject to regulation. In the same sense, the
industry should not be surprised to see regulators zealously protect-
ing the viator’s interests. Lyons also argued that it is important

39. See id. at 787.
40. See id. at 786-87.
41. See id., at 782. The American Council of Life Insurance (ACLI) was also contact-
ed for comments regarding viatical settlements, but did not respond. It did not find this to
be a pressing issue, nor a good way to expend its resources. See National Association of
Insurance Commissioners, Fall 1994 National Meeting, 1994-3 NAIC PROC. 515, 517. The
ACLI has stated that viatical settlement companies “are not affiliated with or sanctioned
by the life insurance industry.” ACLI Pamphlet, supra note 24.
42. See Winter 1992 Report, supra note 28, at 782; June 1993 Report, supra note 9,
at 723-24; Spring 1994 Report, supra note 20, at 360-61.
45. See June 1993 Report, supra note 8, at 723 (Bill Crust of the National Viatical
Association speaking about free enterprise and the right to privacy emphasizing that over-
regulation intrudes on property rights).
47. See id.
48. See id.
for the industry and regulators to agree on issues of disclosure, enforcement, and minimum payouts.49

Based on the research of the Viatical Settlement Working Group and outside comments from members of the viatical industry and NAPWA, the NAIC formulated the regulations it thought were necessary to ensure fairness and prevent fraud and abuse. These include: licensing, filing, reporting, and confidentiality requirements; approval by the chief insurance regulatory official; full disclosure of the ramifications of viatical settlements; assurance regarding the mental capacity of the viator; refund provisions; time restraints on when cash proceeds must be received; and minimum payouts.50 Some states have adopted the Model Act and the Model Regulation as drafted or with modifications.51 Other states have developed their own laws or licensing requirements.52 Still, the viatical settlement industry is not regulated at all in more than half of the states.53 Further, with the expansion of the industry to other people such as the elderly and the development of new treatments for terminal and chronic illnesses, the Model Act and the Model Regulation fail to address some of the new concerns arising, such as longer life expectancies.54 Application of the Models’ minimum payout requirements to longer life expectancies is proving difficult as the industry has begun looking to the elderly and to terminal and chronic illnesses other than AIDS.

C. Focus of Regulation

Two areas must be considered for regulation: viatical settlements and secondary marketing of viatical settlements.

---

49. The biggest gap between these two bodies is the issue of minimum payouts. See id.
50. See June 1993 Report, supra note 8, at 724-27; Summer 1994 Report, supra note 9, at 572-74.
51. See Schultz, supra note 7, at 106-14.
52. States which require licensing of viatical companies or require filing of an application to conduct business include: California, Connecticut, Florida, Illinois, Indiana, Kansas, Maine, Michigan, Minnesota, Louisiana, North Carolina, North Dakota, New York, Oregon, Texas, Virginia, Vermont, Washington, and Wisconsin. See VAA Newsletter, supra note 1.
53. See supra note 7 and accompanying text.
54. See supra note 34 and accompanying text.
1. Viatical Settlements

A viatical settlement is a transaction in which a terminally or chronically ill, or elderly person sells his or her life insurance policy to a third party and receives a lump sum cash payment equal to a percentage of the policy's face value.\(^5\) This money may be used by the seller for any purpose.\(^6\) In some cases the cash proceeds may also be excluded from gross income.\(^7\) The viatical company then becomes the beneficiary of the life insurance policy. The NAIC specifically defines four relevant terms in the Model Act:\(^8\) viatical settlement contract, viatical settlement provider, viatical settlement broker, and viator.\(^9\)

A viatical settlement can involve several parties. The viator is the owner and seller of "a life insurance policy insuring the life of a person with a catastrophic or life-threatening illness or condition or the certificate holder."\(^10\) In general, a viatical settlement provider is the party buying the life insurance policy from the viator.

---

\(^{5}\) The Court in Pardo II defined a viatical settlement as:

[A]n investment contract pursuant to which an investor acquires an interest in the life insurance policy of a terminally ill person—typically an AIDS victim—at a discount of 20 to 40 percent, depending upon the insured's life expectancy. When the insured dies, the investor receives the benefit of the insurance. The investor's profit is the difference between the discounted purchase price paid to the insured and the death benefit collected from the insurer, less transaction costs, premiums paid, and other administrative expenses. Pardo II, 87 F.3d 536, 537 (D.C. Cir. 1996); see also VAA Newsletter, supra note 1 (stating that a viatical settlement is "the sale or absolute assignment of all or part of the ownership of, or beneficial interest in an existing individual policy or interest in a group policy").

\(^{6}\) See VAA Newsletter, supra note 1.

\(^{7}\) See 26 U.S.C. § 101(g) (Dec. 31, 1996); see also infra notes 69-70 and accompanying text (discussing the exclusion of viatical settlement proceeds from gross income).

\(^{8}\) The terms were defined with the underlying purpose of creating a guideline for regulating viatical settlements.

\(^{9}\) Under the Model Act:

[A viatical settlement contract is] a written agreement entered into between a viatical settlement provider and a person owning a life insurance policy [including group policies] of a person who has a catastrophic or life-threatening illness or condition. The agreement shall establish the terms under which the viatical settlement provider will pay compensation or anything of value, which compensation or value is less than the expected death benefit of the insurance policy or certificate, in return for the policyowner's assignment, transfer, sale, devise or bequest of the death benefit or ownership of the insurance policy or certificate to the viatical settlement provider.

VIATICALSETTLEMENTSMODELACT§2(B)(1993).

\(^{10}\) Id. § (2)(C)-(D).
The viatical settlement provider pays "compensation or anything of value, which compensation or value is less than the expected death benefit of the insurance policy," in exchange for the viator’s "assignment, transfer, sale, devise or bequest of the death benefit or ownership of the insurance policy." A viatical settlement broker is someone who "offers or advertises the availability of viatical settlements, introduces viators to viatical settlement providers, or offers or attempts to negotiate viatical settlements" for a fee, commission or other consideration.

Congress has also defined the terms "viatical settlement provider" and "terminally and chronically ill insureds" in the Health Insurance Portability and Accountability Act of 1996 (HIPAA). Under this Act, a viatical settlement provider is defined as any person regularly engaged in the trade or business of viatical settlements. The Act also requires that the viatical settlement provider be licensed or meet certain requirements under the Model Act and the Model Regulation of the NAIC.

At first, some industry participants argued that restrictions were unnecessary because the industry was just starting up. They also argued that the viatical industry would be self-regulatory. Today, almost 10 years since the industry’s birth, the industry is well established and secondary markets have evolved. Contrary to the industry’s predictions, there is very little self-regulation.

Congress has created an incentive for viatical settlements by granting them preferential tax treatment. The HIPAA excludes certain viatical settlements from gross income as of January 1, 1996. Specifically, the Act treats viatical settlements as proceeds of a life insurance contract payable by reason of death, thus excluding the cash payment received upon sale of the patient’s insurance policy from gross income. In order to qualify for preferen-

61. Id.
62. See id. § (2)(A).
65. See id.
66. See Spring 1994 Report, supra note 20, at 360. John Banks, Viatricus, argued that he could see setting up limits, such as minimum payouts, in a mature industry but not in a start-up industry. Id.
67. See id. at 361 (comment by Parker Willson of the National Viatical Association).
68. Compare text accompanying note 44 (arguing that self-regulation is imminent), with note 104 and accompanying text (noting the lack of incentives to self-regulate).
69. See 26 U.S.C. § 101(g).
70. See id. § 101(g)(2)(A).
tial tax treatment, the IRS requires compliance with certain regulatory provisions of the Model Act and the Model Regulation. By taking this action, Congress and the Internal Revenue Service not only provided an incentive for viatical settlements, but also recognize the legitimacy of the viatical settlement industry. Since this is an industry worthy of recognition, it is also worthy of regulation.

The argument for regulation is supported by the text of HIPAA in which the definitions of "viatical settlement provider," "terminally ill insureds," and "chronically ill insureds" all include requirements to meet certain regulatory criteria under the Model Act. While this is not an explicit regulation of the viatical industry, it encourages viatical companies to follow some of the regulatory guidelines of the Model Act. In order to qualify as a viatical settlement provider, a person must be licensed as required by state law or meet the requirements of terminally or chronically ill insureds. In order to qualify as a terminally or chronically ill insured, a person must meet the requirements of sections 8 and 9 of the Viatical Settlement Model Act.

Section 8 requires a viatical settlement provider to disclose certain information to the viator prior to or on the date the viatical settlement contract is entered into. Section 9 is a list of general rules which must be followed by the viatical settlement provider, including: obtaining a written statement regarding the viator's mental capacity and a witnessed document in which the viator consents to the viatical settlement contract; assuring confidentiality; provid-

71. See id. § 101(g).
72. See Schultz, supra note 7, at 119.
73. See 26 U.S.C. § 101(g)(2).
74. 26 U.S.C. § 101(g)(2)(B) provides:

The term "viatical settlement provider" means any person regularly engaged in the trade or business of purchasing, or taking assignments of, life insurance contracts on the lives of insureds described in paragraph (1) [an insured who is chronically ill or terminally ill] if—

(I) such person is licensed for such purposes (with respect to insureds described in the same subparagraph (1) as the insured) in the state in which the insured resides, or
(II) in the case of an insured who resides in a State not requiring the licensing of such persons for such purposes with respect to such insured, such person meets the requirements of clause (ii) [terminally ill insureds] or (iii) [chronically ill insureds], whichever applies to such insured.

75. See VIATIONAL SETTLEMENTS MODEL ACT §§ 8, 9 (1993).
76. See id. § 8.
ing an unconditional refund option; and providing specific duties as to the payment of the cash proceeds. If these requirements are not met, the viatical settlement will not qualify for preferential tax treatment under the Act.

Through the tax code, Congress and the IRS not only have recognized the viatical settlement industry, they have also recognized a need to ensure regulation of the industry and have looked to both the Model Act and state law for such regulation.

2. Secondary Markets

Some viatical companies have turned to secondary markets to protect themselves from some of the risk involved in viatical settlement transactions. One such market involves “fractionalizing,” in which a company facilitates “the sale of life insurance policies from [the patient] to investors at a discount.” These companies sell fractional interests in the patient’s insurance policy to retail investors. The investors may purchase as little as 3% of the benefits of an insurance policy and thus pay at a discount rate. Fractionalizing spreads the risk among investors and allows each investor to have an interest in more than one life insurance policy.

Viatical companies can also purchase policies with long life expectancies at discounts and then resell them later as short-term viatical policies for higher prices. This, too, makes transactions involving longer life expectancies less risky and more appealing, opening the door for transacting with the elderly and others with longer life expectancies.

The SEC attempted to regulate the fractionalizing market, but the Court of Appeals for the District of Columbia in Pardo II denied the Commission jurisdiction over such investments. The SEC has not given up its argument. Although the SEC’s petition for rehearing was denied, the court’s opinion arguably left the door open for the SEC. The court clarified that it was not creating a

77. See id. § 9.
78. See 26 U.S.C. § 101(g).
79. See Barbara Mannino, Moving Beyond The Learning Curve (Emergence of Viatical Insurance Settlements), BEST'S REV.—LIFE-HEALTH INS. EDITION, Aug. 1997, at 72, 73.
81. See Pardo II, 87 F.3d 536, 539 (D.C. Cir. 1996).
82. See Mannino, supra note 79, at 73.
83. The SEC is only attempting to regulate the practice of fractionalizing, not the entire viatical industry. See id. at 74; infra note 155 and accompanying text.
84. See Pardo I, 898 F. Supp. 14; Pardo II, 87 F.3d at 549 (Wald, J., dissenting).
85. See Securities and Exchange Commission v. Life Partners, Inc. & Pardo, 102 F.3d
bright-line rule and that in other cases of fractionalizing, viatical settlements may constitute securities.\textsuperscript{86}

II. REGULATING THE VIATIONAL SETTLEMENT INDUSTRY

A. Approaching Regulation

Since the beginning of the industry, there has been and continues to be a debate over the ethics of viatical settlements.\textsuperscript{87} From a public policy viewpoint, the debate is useful in identifying what types of regulation will be effective and what amount of regulation is necessary to protect all parties involved. However, because so many viewpoints exist, it is difficult to pinpoint which is the best approach to regulation. This difficulty is compounded by an inability to place viatical settlements in any other regulated category such as an insurance or goods transaction.

Although viatical settlements and the viatical settlement industry have been defined by the legislature, courts, agencies, and commentators, there has been little success in defining how to regulate the industry. There has been greater success in determining what viatical settlements are \textit{not} to be regulated as. Viatical settlements are not insurance contracts.\textsuperscript{88} Straight viatical settlements are not securities.\textsuperscript{89} Viatical settlements stretch existing laws regulating the buyer—seller transaction.\textsuperscript{90}

The next step is to determine what viatical settlements \textit{are}. Viatical settlements are sales transactions between the owner of a life insurance policy and the company purchasing the policy for a cash payment.\textsuperscript{91} In most states, life insurance policies are treated

\textsuperscript{86} See id. at 588; infra note 169 and accompanying text. Further, in Pardo I, the court had ruled in favor of the SEC. See Pardo I, 898 F. Supp. at 14. There was a strong dissenting opinion by Justice Wald in both Pardo II and Pardo III. See Pardo II, 87 F.3d at 549 (Wald, J., dissenting); Pardo III, 102 F.3d at 589 (Wald, J., dissenting).

\textsuperscript{87} See id.

\textsuperscript{88} See Pardo II, 87 F.3d at 18-19 ("Viatical settlements do not transfer or distribute risk."). The risk to the buyer that is involved—that the seller will live longer than expected—is "inherent in any investment and does not serve the central purpose of insurance: to transfer risk from the insured to the insurer." \textit{Id}. This transfer of risk has already been done by the insurance company issuing the policy. See id.

\textsuperscript{89} There is some debate over whether the secondary market of viatical settlements does involve securities law. See Pardo I, 898 F. Supp. at 22; Pardo II, 87 F.3d at 549 (Wald, J., dissenting); infra notes 151-175 and accompanying text.

\textsuperscript{90} See id. at 17 n.2.

\textsuperscript{91} See VAA Newsletter, supra note 1.
as the intangible personal property of the owner which may be freely assigned or sold by the owner of the policy. 92

Adding to the difficulty of determining how to regulate viatical settlements, the industry has filtered into numerous areas. With secondary marketing of viatical settlements, viatical investments begin to look like securities. 93 If so, the SEC should become involved in regulating the industry. 94 With the enactment of the HIPAA, Congress has taken a step in regulating the industry, 95 and tax law may soon play an even bigger role if the elderly begin selling their policies to avoid estate taxes. 96 There is also an argument that the Uniform Commercial Code (UCC) may be implicated. 97 Several approaches to regulating the viatical industry have been proposed.

At one extreme are proponents of little or no regulation that argue that regulation is unnecessary because there have been no complaints of abuse within the industry. In Pardo II, the court stated that the lack of regulation in the secondary market is due to the fact that "neither policyholders nor investors have complained of any abuse." 98 Judge Wald, dissenting, countered with the argument that the fact that no complaints have yet been made does not render abuse impossible or regulation unnecessary. 99 One reason for a lack of complaints in the secondary market is that it is young and rapidly expanding. 100 Thus, the potential for abuse may be intensifying. 101 Judge Wald further argued that "security laws are intended to be prophylactic and prevent abuses before they arise." 102

92 See id.
93 See infra notes 159-70 and accompanying text for a discussion of the securities aspects of viatical investments in the Pardo cases.
96 See Daniel Golden, Life Insurance Policy-Buying Companies Shortchange the Dying, Heirs, BOSTON GLOBE, Dec. 15, 1997, at A11 (stating that viatical companies are "encouraging healthy elderly people to sell policies to avoid estate taxes").
98 Pardo II, 87 F.3d 536, 539 (D.C. Cir. 1996).
99 See id. at 556 (Wald, J., dissenting).
100 See id.
101 See id.
102 Id. The industry is not free from abuse. For example, Florida has set up a hotline which people can call to ask about abuses by viatical companies. See John Finotti, Investigating Alternatives Diversity Can Mean More Than Just Putting Your Money in Stocks, FLA. TIMES UNION, Dec. 28, 1997, at H1 (warning that before investing, the hotline should be checked for complaints against viatical companies); see also Mannino,
There are also proponents of self-regulation. However, there is not much incentive for self-regulation. Only a minority of states require licensing. This does not give viatical companies of other states any incentive to be licensed; by not seeking a license viatical companies can avoid filing and reporting requirements. The self-regulating approach could be successful if more incentives were created.

As an example, the Viatical Association of America (VAA) was created in 1994 as a non-profit national trade association of viatical settlement companies. The VAA is a self-regulatory association which encourages high ethical standards. The VAA is dedicated to advocating the rights of both viators and member viatical companies before Congress and state legislatures and agencies. Member companies support regulation of the viatical settlement industry and licensing of viatical companies. The VAA and its member companies believe that reasonable and fair regulation by the states is in the best interest of both viatical companies and viators. The VAA supports regulations regarding confidentiality, viator privacy, disclosure requirements, and licensing. Some governmental incentive for this sort of self-regulation is also provided by the HIPAA.

These incentives may be meaningless if potential viators are unaware of either them or viatical settlements. As discussed in this Comment, few people are aware of all the options available to them. Moreover, the consumer is in a desperate and vulnerable

---

supra note 79, at 74 (describing two cases of abuse: one in which the viatical company defrauded investors, and one in which the viatical company defrauded viators). Further, because there is a lack of regulation, abuse likely remains undiscovered.

103. See supra note 44 and accompanying text.

104. See supra note 7 and accompanying text.

105. See VIATIONAL SETTLEMENTS MODEL ACT § 3, 6 (1993) (stating that filing and reporting obligations must be met to obtain a license).

106. See VAA Newsletter, supra note 1.

107. See id.

108. All members of the VAA have pledged to obtain a license to do viatical business in states where licensing or other authorization is required. See id. In states where no licensing is required, members have pledged not to do business there. See id.

109. See id.

110. See id.

111. See supra notes 71-75 and accompanying text (discussing the HIPAA’s favorable tax treatment of viatical settlement proceeds).

112. See supra note 20 and accompanying text.
state and may not have the resources or desire to survey viatical companies. Thus, the first step in any regulatory approach, particularly self-regulation, would be to educate the public on viatical settlements. Viatical companies will have more incentive to be self-regulating if the public better understands viatical settlements and other available options.

States have found it difficult to regulate viatical settlements, and to a greater degree the secondary market of viatical settlements, under existing buyer-seller laws. Therefore, states began passing viatical settlement regulations to protect viators from being exploited and to ensure confidentiality, privacy and full disclosure. This legislation, codified in the insurance sections of state codes, gives state insurance commissioners and administrators control over the viatical industry. This regulation includes requirements regarding full disclosure and voluntary consent, confidentiality guarantees, protection from unfair competition, recording duties, licensing, and minimum discount rates.

Such state legislation is a positive step toward regulating the viatical settlement industry, but has been a very small step. Many states have not implemented these regulations. Only about twenty states require licensing of viatical companies. Those states often disagree over what and how much regulation is necessary and this disparity may cause abuse between viatical companies. As the industry expands, the original legislation geared toward terminally ill patients with short life expectancies fails to

---

114. Another way to deal with this problem is to stretch existing law to include viatical settlements. The SEC has already attempted to do this with the secondary marketing of viatical settlements. See infra notes 155-58 and accompanying text.
115. See Pardo I, 898 F. Supp. at 17 n.2; Schultz, supra note 7, at 106-14 (providing some of the general and specific regulations adopted state-by-state).
117. See id. at 110 (“Many states have not yet codified viatical regulations, . . . leaving much of the terminally ill population without protection from potential abuses by viatical settlement purchasers.”).
118. See VAA Newsletter, supra note 1.
address new issues involving viators with longer life expectancies, such as the elderly.\textsuperscript{121}

The Model Act and the Model Regulation are a step toward uniform regulation of the industry, but they are only guidelines and depend on self-regulation.\textsuperscript{122} Most states have not adopted these regulations. In addition, it is difficult to apply the Models to the expanding sectors of the industry. First, these groups did not participate in the drafting process and therefore their needs and interests were not addressed. Second, the minimum payout figures in place give these groups the least amount of money. Because these people are likely to live longer, they will need longer term financial resources. A large lump sum of cash will not provide this, and further, may result in the viator’s ineligibility for state and federal entitlement programs. Finally, because these viators have longer life expectancies, they may need additional protection in some areas: the viatical company will be checking on the person’s health status for a longer period of time, and it is more likely that the person’s policy will be sold to another viatical company or fractionalized for other investors.

The Model Act and the Model Regulation do not address the secondary market for viatical settlements. The only attempt at regulating these markets has been by the SEC. The SEC has not yet been successful in taking control over fractionalizing of viatical settlements, although in some situations the SEC’s approach may work.\textsuperscript{123}

Regulation of the viatical settlement industry will benefit both viators and viatical companies.\textsuperscript{124} Regulation of the secondary market for viatical settlements will protect investors.\textsuperscript{125} There are many requirements that can be made of viatical companies.\textsuperscript{126} The question, then, is: What should be regulated, and to what extent?

\textsuperscript{121} See Winter 1995 Report, supra note 5, at 767; Spring 1996 Report, supra note 119, at 618.

\textsuperscript{122} See supra notes 105-10 and accompanying text for discussion on self-regulation.

\textsuperscript{123} See infra notes 169-70 and accompanying text.

\textsuperscript{124} See VAA Newsletter, supra note 1; see also Spring 1996 Report, supra note 119, at 618.


\textsuperscript{126} See VIATICAL SETTLEMENTS MODEL ACT §§ 3, 5, 6, 8, 9 (1993); VIATICAL SETTLEMENTS MODEL REGULATION §§ 1, 2, 3, 4, 5 (1994); see also Schultz, supra note 7, at 106-14 (citing state viatical regulations).
B. Regulation of Viatical Settlements

As a starting point, viatical settlements are defined and restricted by some existing state law and the Model Act and Model Regulation. The HIPAA also defines viatical settlements and requires that certain regulations be followed before viatical settlements may benefit from the preferential tax treatment.\textsuperscript{127}

One area of consensus is that full disclosure should be made to potential viators prior to entering into the contract.\textsuperscript{128} Many patients do not know what a viatical settlement is and what its consequences are.\textsuperscript{129} There are many important consequences and alternatives that should be discussed with each person.\textsuperscript{130} The VAA has created a list of important ramifications that should be presented to and considered by potential viators.\textsuperscript{131}

First, the proceeds from viatical settlements may affect the viator's eligibility for some state- or federal-based entitlement programs.\textsuperscript{132} For example, accepting a large cash payment for a life insurance policy may result in the loss of disability income.\textsuperscript{133}

Second, the viatical settlement may have tax implications. Specific criteria must be met under 26 U.S.C. § 101 before a viatical settlement is excluded from gross income.\textsuperscript{134} Therefore, while some sales of viatical settlements may receive preferential tax treatment under section 101, others may still be taxable as income to the viator.\textsuperscript{135}

Third, there are many alternatives to viatical settlements which may serve the needs of the potential viator better than a viatical settlement.\textsuperscript{136} These include taking out the maximum loans on the

\textsuperscript{127} See 26 U.S.C. § 101(g) (Dec. 31, 1996); supra notes 72-73 and accompanying text.

\textsuperscript{128} See VAA Newsletter, supra note 1; Spring 1994 Report, supra note 20, at 361.

\textsuperscript{129} See Spring 1994 Report, supra note 70, at 361.

\textsuperscript{130} See VAA Newsletter, supra note 1; National Association of Insurance Commissioners, December 1993 National Meeting, 1993-4 NAIC PROC. 642, 649 [hereinafter December Report].

\textsuperscript{131} See VAA Newsletter, supra note 1 (stating that the VAA “strongly recommend[s] that legal and financial advice be sought to determine how a viatical settlement may impact [each persons] specific tax and entitlement status”).

\textsuperscript{132} See id.; December Report, supra note 130, at 649.

\textsuperscript{133} See December Report, supra note 130, at 649.


\textsuperscript{135} See VAA Newsletter, supra note 1; December Report, supra note 130, at 649.

\textsuperscript{136} See VAA Newsletter, supra note 1.
insurance policy, determining if the life insurance company offers an accelerated death benefits program, obtaining the cash surrender value of the life insurance policy, and borrowing from friends or family.\textsuperscript{137}

Fourth, potential viators should consider the effect a viatical settlement may have on other people, particularly beneficiaries of the life insurance policy. By transferring the life insurance policy to the viatical company, the viatical company becomes the beneficiary of the policy.\textsuperscript{138} If the viator transfers all rights to the insurance policy, the original beneficiaries are cut off from receiving proceeds.\textsuperscript{139}

Additionally, regulation is necessary at this step to ensure privacy and confidentiality. Before entering into a viatical settlement, the viatical company will obtain medical information regarding the viator.\textsuperscript{140} Based on this information, the viatical company determines the viator’s life expectancy.\textsuperscript{141} Regulation may be particularly important in the secondary markets because the viator’s life insurance policy will be passed on to more than just the viatical company with whom the viator dealt. Thus, the viator’s policy and medical information will not be kept as confidential as the viator may expect. At the least, the viatical company should disclose to the viator that it will be fractionalizing or later selling the life insurance policy.\textsuperscript{142}

Once a viatical settlement is made, additional privacy issues will arise. The viatical company will do a periodic status check on the viator.\textsuperscript{143} Regulation is needed to make this as least intrusive as possible and, if possible, to eliminate it altogether. Time is very

\textsuperscript{137} See December Report, supra note 130, at 649; see also VAA Newsletter, supra note 1. When borrowing money, the life insurance policy may be used as collateral to secure the loan. See id. However, if this route is taken, it must be determined whether securities laws will be implicated.

\textsuperscript{138} See ACLI pamphlet, supra note 24, at 7-8.

\textsuperscript{139} See id.

\textsuperscript{140} See Spring 1994 Report, supra note 20, at 360.

\textsuperscript{141} See id.

\textsuperscript{142} In states that treat life insurance policies as any other personal property, once the viator sells his or her policy, all rights to the policy have been sold. See VAA Newsletter, supra note 1. Thus, the viatical company may transfer, sell, assign or do anything it wants with the policy, just as the viator was able to. See id.

\textsuperscript{143} See Spring 1994 Report, supra note 20, at 360.
precious for the terminal patient and it is not well spent with visits from the viatical company.

Another highly disputed area of regulation is minimum payouts.\(^{144}\) One reason for this is that viatical companies believe the best way to ensure fairness is to allow as much capital as possible to flow into the industry.\(^{145}\) Another basis for the dispute is the extreme difficulty in estimating life expectancy. The Model Regulation includes minimum payouts in recognition that some limit was necessary.\(^{146}\) The numbers chosen are based on an actuarial analysis conducted by the Life and Health Actuarial Task Force.\(^{147}\) Enforcing minimum payouts ensures that viators will receive something for their life insurance policies. However, there are several problems with using these, or any, numbers. It is difficult to predict life expectancy, and reliable statistics regarding such numbers would take several years to obtain.\(^{148}\) Further, it is even more difficult to apply these numbers to viatical settlements involving the elderly or chronically ill patients with longer life expectancies.\(^{149}\)

\(^{144}\) See Schultz, supra note 7 at 112-14.
\(^{146}\) See Spring 1996 Report, supra note 119, at 618.
\(^{147}\) See Spring 1994 Report, supra note 20, at 362. The Model Regulation provides that:

<table>
<thead>
<tr>
<th>Insured's Life Expectancy</th>
<th>Minimum Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>of Face Value Less</td>
</tr>
<tr>
<td></td>
<td>Outstanding Loans</td>
</tr>
<tr>
<td></td>
<td>Received by Viator</td>
</tr>
</tbody>
</table>

- Less than 6 months      [90%]
- At least 6 but less than 12 months [85%]
- At least 12 but less than 18 months [75%]
- Eighteen months or more  [70%]

\(^{148}\) See Spring 1996 Report, supra note 119, at 618 (comments of Carol Ostapchuk (Fla.), reporting on the actuarial analysis of minimum payouts during a meeting of the Viatical Settlements Working Group of the Life Insurance Committee).

\(^{149}\) Those with longer life expectancies receive less money, but it is likely they will need the most money. Further, these long-term viatical settlements are really an entirely different product and thus, should not be treated the same as the short term viatical settlements originally targeted by the industry. See id. (comments of Eleanor Perry (Vt)).
Regulation of this issue is important for viators and viatical companies because both parties assume risks with respect to the viator's life expectancy. The risk increases as life expectancy becomes less predictable—for example, with the elderly. One argument against requiring minimum payouts is that viators will not have the opportunity to get the best deal possible because companies will make offers close to the minimum numbers. However, because viators are in desperate need of money, they have an inferior bargaining position. Minimum payouts can therefore prevent companies from taking advantage of viators.

C. Regulation of Secondary Markets

Regulation of secondary markets is a different arena. State laws dealing with viatical settlements and the Model Act and the Model Regulation are only aimed at protecting viators. Therefore, legislatures must amend existing laws and models or create another set of regulations to regulate secondary markets. Regulation of secondary markets is important for the same reasons viatical settlements need regulation. There is a potential for abuse, particularly because none of the existing viatical regulations address the secondary market. Furthermore, as the primary viatical industry grows due to a broadened client base and Congress' preferential tax treatment of viatical settlements, the secondary market will grow with it and thus increase the potential for abuse.

There are additional concerns specific to the secondary market. For example, confidentiality issues are magnified as a viator's life insurance policy, and thus his or her medical records, are made available to any number of potential investors. Where a viatical company resells a long-term policy as short-term policy, the viator

---

152. At the 1996 Spring meeting of the National Association of Insurance Commissioners, Commissioner Glenn Pomeroy (N.D.) stated there were insurable interest concerns regarding the secondary marketing of viatical settlements, and therefore, a specific prohibition against secondary marketing should be considered. See Spring 1996 Report, supra note 119, at 618.
153. See Pardo II, 87 F.3d at 556 (Wald, J., dissenting) (arguing that this increase is likely to lead to abuse, and therefore, securities laws should be implicated to prevent such potential abuse).
154. Before investing, investors will want to know the life expectancy of the viator as well as the value of his or her life insurance policy.
will deal with completely new companies or investors. These new investors, with whom the viator has never dealt with nor even seen before, will now call the viator to keep track of his or her health status. Viatical companies that do engage in secondary marketing should disclose this to viators prior to the settlement.

The potentially simple regulation of the secondary marketing of viatical settlements under securities laws was raised by the SEC in its attempt to regulate fractionalization in the *Pardo* cases. In fact, "the securities laws are the only currently existing regulatory scheme by which investors in viatical settlements can be protected." One problem with applying securities laws is that it appears that not all fractionalizing would be treated the same way. Because of the ambiguity that exists, using this system to regulate viatical settlements is likely to cause enforcement problems and lead to abuses. Therefore, a stronger approach to regulating the secondary markets is necessary. This may be accomplished by defining and addressing viatical settlements in the securities laws. Alternatively, the Model Act, Model Regulation, and state viatical regulations may be an appropriate place to undertake regulation of the secondary markets.

The Court of Appeals for the District of Columbia Circuit has ruled upon the applicability of securities law to secondary viatical transactions in the *Pardo* cases. In *Pardo I*, the District Court held that fractionalizing was subject to securities law. This finding was reversed in *Pardo II*, in which the Court of Appeals held the viatical company’s activity did not fall under the SEC’s jurisdiction. In *Pardo III*, the court stated that under a different set of facts, fractionalizing may be subject to securities law. While the court did not formulate specific criteria, it stated that at least "one entrepreneurial post-purchase service" is necessary.

---

156. *Pardo II*, 87 F.3d at 556 (Wald, J., dissenting).
157. *See Pardo III*, 102 F.3d 588 (D.C. Cir. 1996) (holding that whether tractionalizing is subject to the securities laws depends on the facts of the case).
159. *See Pardo II*, 87 F.3d at 549.
160. *See Pardo III*, 102 F.3d at 588.
161. Id. at 590.
In *Pardo I*, the SEC brought suit against Life Partners, Inc. (LPI) alleging violations of securities laws. LPI facilitates the sale of viatical settlement to investors at a discounted price; specifically, LPI finds, evaluates, and typically is assigned the life insurance policy. Benefits are paid to LPI, who then pays the investors. In determining whether LPI's action should be subject to securities laws, the court applied the *Howey* test. Under the *Howey* test, an investment contract is subject to the securities laws when it is a “transaction or scheme whereby a person invests his money [1] in a common enterprise and [2] is led to expect profits [3] solely from the efforts of the promoter or a third party.”

The court in *Pardo I* held that all three prongs were met and thus LPI's transactions were subject to securities laws. The court granted a preliminary injunction to the SEC on the basis that LPI was selling unregistered securities in violation of the Securities Act of 1933 and the Securities Exchange Act of 1934. The court further ordered LPI to comply with the applicable securities laws. However, the Court of Appeals in *Pardo II* reversed, holding that while the first two prongs of the test were met, LPI's activities did not fall under the third prong and were not subject to securities laws. The court found that the SEC failed to show the investor's profits depended predominantly upon the efforts of LPI. The court hung its hat on the fact that LPI performed primarily pre-purchase services and its post-purchase services were simply ministerial.

---

163. *See id.*
164. *See id.*
165. *See id.* at 19-22; *Pardo II*, 87 F.3d at 542-48 (D.C. Cir. 1996); *Pardo III*, 102 F.3d at 588. The SEC admits that straight viatical settlements are not securities. *See Pardo I*, 898 F. Supp. at 19.
167. *See Pardo I*, 898 F. Supp. at 22 (“LPI’s basic policy is an investment contract that is subject to federal securities law.”).
168. *See id.* at 24; *see also* 15 U.S.C. §§ 77e(a), 77e(c) (1933) (section 5 of the Securities Act of 1933, prohibiting interstate commerce of unregistered securities); 77q(a) (1933) (section 17(a) of the Securities Act of 1933, prohibiting fraudulent interstate transactions); 78o(a) (1934) (section 15(a) of the Securities Exchange Act of 1934, setting forth registration requirements).
170. *See Pardo II*, 87 F.3d at 536.
In dissent, Judge Wald criticized the majority’s emphasis on the fact that LPI’s activities are merely pre-purchase activities. Judge Wald advocated an approach which would allow pre-purchase managerial activities to satisfy the Howey test when they are the predominant cause for realization of profits.\(^\text{17}\) Judge Wald found that LPI’s pre-purchase activities met the third prong of the Howey test because the investor’s profits depend on LPI’s accuracy in estimating the viator’s life span.\(^\text{17}\) Judge Wald noted that LPI’s promotional materials emphasize its thorough assessment of the viator’s life expectancy. Further, investors rely on LPI’s assessment because they can only review LPI’s assessment and have no access to medical records beyond what LPI has obtained. LPI’s estimate is critical because the longer the viator remains alive beyond what was predicted, the lower the investor’s profits will be.\(^\text{17}\)

In *Pardo III*, the Court of Appeals rejected a bright-line rule that fractionalizing could *never* be regulated under securities laws, stating that “we only held ‘that [1] pre-purchase services cannot by themselves suffice to make the profits of an investment arise predominantly from the efforts of others, and that [2] ministerial functions should receive a good deal less weight than entrepreneurial activities.’” The court thus made it possible for the SEC to regulate secondary markets where there is at least one entrepreneurial post-purchase service.\(^\text{17}\) On the other hand, the court also made it possible for viatical companies to avoid securities regula-

\(^{17}\) See *id.* at 554 (“I have found no case which holds, as the majority here does, that pre-purchase activities alone cannot satisfy Howey’s third prong.”) (Wald, J. dissenting).

\(^{17}\) See *id.* at 555 (Wald, J., dissenting).

\(^{17}\) See *id.* (Wald, J., dissenting).

\(^{17}\) Pardo III, 102 F.3d 587, 588 (D.C. Cir. 1996) (quoting *Pardo II*, 87 F.3d at 548).

\(^{17}\) See *id.* at 588 (“Absent even one entrepreneurial post-purchase service—and the SEC could identify none—there simply is no on-going common enterprise involved in owning an interest in an insurance contract from which the profit depends entirely upon the mortality of the insured.”). Because the holding in *Pardo II* rested on the fact that LPI’s profits “did not derive predominantly from the efforts of a party or parties other than the investors,” the court has left the door open for the SEC to bring fractionalizing under securities laws. *See Pardo II*, 87 F.3d at 537, 545-48 (applying the Howey test). Where the facts allow the SEC to prove this third factor, under *Pardo II* and *Pardo III*, the SEC’s jurisdiction over those investments in viatical settlements will be upheld. However, there is some disagreement over whether the Court of Appeals really leaves the door open for the SEC to claim jurisdiction. *See Pardo III*, 102 F.3d at 589 (Wald, J., dissenting) (arguing that the majority creates a bright-line rule).
tions by engaging in what the *Pardo* court found to be only pre-purchase activities. Thus, even with the SEC's effort, secondary markets will continue to be unregulated.

**III. CONCLUSION**

The viatical settlement industry has expanded rapidly in its first decade, moving from a client base of AIDS patients to one of numerous terminally and chronically ill patients and the elderly. Several attempts at regulation through the states, Congress, and the NAIC have been made, but have not been successful. The first step in regulation, defining viatical settlements and the viatical industry, has already been taken. The next step is to educate the public. People can better protect themselves if they are aware of all of the options and protections available to them. Finally, regulations must be implemented. Several approaches to regulation have been discussed, including self-regulation, bringing viatical settlements under existing laws, and national viatical regulations. Regulation of the viatical industry is necessary to protect viators from exploitation at a time in their life when they are most susceptible to abuse. Regulation will also protect viatical companies from abuse within the industry. Further, as a public policy matter, regulation will encourage high ethical standards within the industry.

JOY D. KOSIEWCZ