

**UNITED STATES SENATE
SPECIAL COMMITTEE ON AGING**



LIFE SETTLEMENTS: RISKS TO SENIORS

**SUMMARY OF
COMMITTEE INVESTIGATION**

MAJORITY STAFF

SENATOR HERB KOHL, CHAIRMAN

APRIL 29, 2009

LIFE SETTLEMENTS

Life settlements constitute a multibillion dollar industry.¹ A recent research report estimated that in 2008, the life settlement industry transacted business involving \$12 billion worth of U.S. life insurance policies' face values.² However, some academics and practitioners have questioned the validity of these figures given that life settlement providers are not required to report the volume of policies purchased to a central depository, and estimate that the potential life settlement market could exceed \$160 billion.³ While life settlements may be a valuable way for seniors to derive previously inaccessible economic value from their life insurance policies, recent news reports,⁴ complaints by state law enforcement,⁵ and notices from the Financial Industry Regulatory Authority (FINRA)⁶ have highlighted the dangers that life settlements may pose to seniors. Given these potential dangers and in response to numerous reports of industry misconduct and improper marketing, the U.S. Senate Special Committee on Aging (Committee) recently initiated an investigation into the composition and business practices of life settlement providers

The Committee requested information from select life settlement companies to better understand their business practices and how these providers are educating seniors about potential risks of entering into a life settlement. Specifically, the Committee requested information on these providers' (1) disclosure policies, (2) premium financing activities, (3) tax rewards, and (4) federal and state enforcement or disciplinary-related actions. The providers were selected based on their involvement within the life settlement secondary market, size of the assets under their management, and the extent to which they were involved in a federal or state enforcement action. The information collected is not representative of the entire life settlement industry.

The Committee's preliminary findings indicate:

- (1) life settlements may pose unintended consequences for seniors;
- (2) the Internal Revenue Service (IRS) has not clarified life settlements' tax liabilities;
- (3) most state securities regulators consider life settlement investments to be securities while the Securities and Exchange Commission (SEC) has yet to clarify its position; and
- (4) states are taking action to increase transparency in the life settlements market, but lack consistency.

¹ A life settlement is the sale of a life insurance policy by the insured person—generally 65 or older—to a third party for a cash payment. The third-party purchaser becomes the owner of the policy, pays all future premiums owed on it, and collects the death benefit when the insured person dies.

² Life Policy Dynamics, LLC, *Life Settlement Market Analysis 2008*, (Washington, D.C.: 2009).

³ Deloitte Consulting LLP and the University of Connecticut. *The Life Settlement Market: An Actuarial Perspective on Consumer Economic Value*, 2005. Conning & Co. Research, *Life Settlements: New Challenges to Growth 2008*. (Hartford, Connecticut, 2008).

⁴ Matthew Goldstein, "Death Bonds: Inside Wall Street's most macabre investment scheme yet," *Business Week* (July 30, 2007).

⁵ *People of the State of New York v. Coventry First LLC et al.*, New York Supreme Court, New York County, No. 404620-2006, (10/26/2006). http://www.oag.state.ny.us/media_center/2006/oct/complaint.pdf.

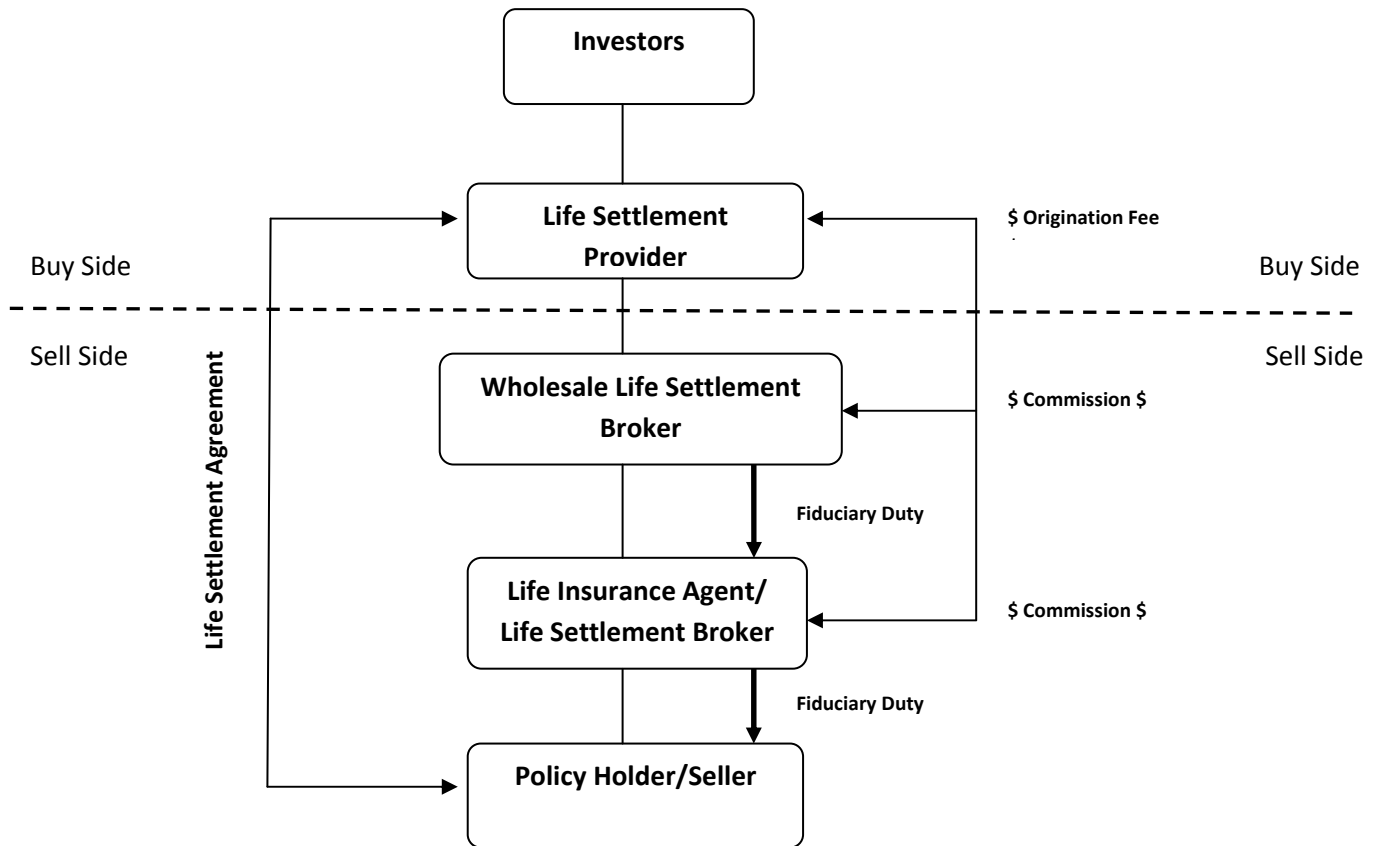
⁶ FINRA, Notice to Members 06-38, August 2006 and Investor Alert, "Seniors Beware: What You Should Know About Life Settlements" February 2007.

BACKGROUND

The life settlement market emerged out of the viatical settlement industry that developed in the 1980s as a source of liquidity for AIDS patients and other terminally ill policyholders with life expectancies of less than two years.⁷ Unlike viaticals, life settlements involve policyholders who are not terminally ill, but generally have a life expectancy of between two and ten years. According to one life settlement research firm, life settlements are a potential source of income for policyholders and are becoming an emerging alternative asset class for investors. Their research indicates that the annual and cumulative U.S. life settlement market grew from an estimated \$2 billion in 2002 to \$12 billion in 2007. The research firm projected in 2007 that growth should remain strong over the next years—growing from 12 billion in 2007 to approximately \$21 billion in 2012.⁸

The life settlement industry involves multiple players, such as life insurance companies, insurance agents, brokers, providers, and investment firms. (See figure 1 for an illustration of the typical life settlement transaction.)

Figure 1: Description of Life Settlement Transactions



Source: Leimberg, Callahan, Casey, Magner, Reed, Rybka, and Siegert, *Life Settlement Planning*, (Tools & Techniques, Cincinnati, Ohio: 2008.)

⁷ Viatical settlements refer to policy holders that have “catastrophic” or “life threatening” illnesses or conditions. Some viatical settlement laws also pertain to policy holders with chronic medical conditions, and others contain no discernible limitation.

⁸ Conning & Co. Research, *Life Settlements: New Challenges to Growth 2008*. (Hartford, Connecticut, 2008).

As shown in Figure 1, one of the key players in the life settlement transaction is the life settlement broker. A life settlement broker negotiates the sale of a life insurance policy between the policy owner and the buyer (the life settlement provider) for a fee or commission.⁹ Some industry experts have raised concerns about the transparency of broker commissions, and believe that there should be full disclosure of brokers' activities, including their fees and compensation—which purportedly may be as high as 35 percent of the policy's purchase price.¹⁰

INVESTIGATION RESULTS

In November 2008, the majority staff of the Special Committee on Aging began an investigation of the growing life settlement industry. The Committee requested information from different players of the life settlement industry, including brokers and life settlement providers.¹¹ Based on information obtained from select life settlement brokers, the Committee determined that these providers purchased policies from individuals with an average age ranging from 65 to 80 years, and that the average age of policies ranged from 6 to 8 years. The Committee also found that between January 2003 and February 2009, the total policies purchased by these companies varied, ranging from 567 to 6,200.

Life Settlements May Pose Unintended Consequences for Seniors

Given that retirees have recently seen their investment portfolios begin to shrink due to the economic downturn, seniors may increasingly turn to selling assets, such as their life insurance policies. While life settlements are a valuable source of liquidity, life settlements may pose unintended consequences, such as unexpected tax liabilities, decreased access to insurance coverage, board release of an individual's private health information, and financial and legal liability if the policy is rescinded due to participation in a stranger-originated life insurance (STOLI),¹² or other fraudulent transaction. In addition, life settlement brokers and other middlemen, who receive large commissions, may be aggressively targeting seniors to sell their life insurance policy on the secondary market. As a result, some regulators have noted that seniors need to be aware of the following:

Unexpected Tax Liability. The lump sum payment that seniors receive in exchange for their life insurance policy can be taxable. In addition, seniors may not be aware that any incentives provided in exchange for a life settlement policy may also be taxable.

⁹ Leimberg, Callahan, Casey, Magner, Reed, Rybka, and Siegert, *Life Settlement Planning*, (Tools & Techniques, Cincinnati, Ohio: 2009.)

¹⁰ Jane Bryant Quinn. *Putting Your Life Policy in Someone Else's Hands*. *The Washington Post*. Sunday, June 22, 2008.

¹¹ The Committee collected information from the following life settlement providers and brokers: Coventry, Life Equity, Lifeline, Life Partners, Peachtree, Advanced Settlements, Mosaic Management Group. The Committee also receive information from industry associations, such as the Life Insurance Settlement Association, the Life Settlement Institute, and the Institutional Life Markets Association, among others.

¹² STOLI involves the creation of a new contract of life insurance where the true "owner" of the policy at inception does not have a valid insurable interest in the life of the insured. It is solely to create an asset for investment purposes.

Committee Finding(s)

-- All of the life settlement providers that submitted information to the Committee acknowledged that they did not provide an opinion on the tax liabilities affecting seniors' and investors' life settlement transactions, but rather advised individuals to consult a tax advisor. Only one provider noted in their response to the Committee that they offer their policy owners with an informational pamphlet on the issue. The provider also noted that they do not take a position or offer any tax advice other than imploring the policy owner to consult their tax advisor with regard to any tax consequences because the area is "exceptionally murky." The company urged the Committee to consider legislation which clearly defines any tax liability for policy owners.

Confidentiality of Personal Information. When an individual engages in a life settlement transaction, they agree to release their medical and other personal information to the provider so that the buyer will be able to determine the worth of the policy. Once that information is obtained, it may be shared with other parties or resold to new investors without the policy holder's knowledge.

Committee Finding(s)

--All of the life settlement providers that submitted information to the Committee noted that they are subject to certain federal and state privacy statutes, such as the Health Insurance Portability and Accountability Act, and do not share information with other parties without the express permission of the insured. However, the Committee was not able to determine the extent to which such information was provided to multiple sources once permission was obtained.

Decreased Insurance Capacity. An individual has a finite amount of "insurance capacity" on his or her life. Once a senior sells his or her life insurance policy, the senior may be unable to obtain more life insurance should a legitimate need for life insurance arise. Scott Berlin, Senior Vice-President at New York Life Insurance Company, testified at a Florida state hearing, "that one of the things that seniors may not understand is that there's a certain amount of insurance an individual can qualify for—that insurance sold to someone else does not free up their capacity for additional insurance coverage."¹³

Committee Finding(s)

--Only two of the five providers that submitted information to the Committee stated that they disclose the possible insurance capacity limitation to the insured.

Financial and Legal Liability if Life Insurance Policy is Rescinded. Seniors may be financially and/or legally liable if a fraudulent scheme is uncovered related to their life settlement transaction. For example, a January 2009 report by the Florida Office of Insurance Regulation noted life insurers in Florida filed three multi-million dollar federal lawsuits in 2008 alleging the true nature of the transactions were allegedly misrepresented.¹⁴ While there was virtually no litigation involving life

¹³ Florida Office of Insurance Regulation. Hearing Transcript: *Stranger Owned Life Insurance (STOLI)*. Public Hearing, August 28, 2008.

¹⁴ Florida Office Of Insurance Regulation. *Stranger-Originated Life Insurance (STOLI) and the Use of Fraudulent Activity to Circumvent the Intent of Florida's Insurable Interest Law*. Report of Commissioner, Kevin M. McCarty. (January 2009).

settlements in 2005, the Committee found that there are currently over 100 cases being litigated nationwide.¹⁵

IRS Has Not Yet Clarified the Tax Liability of Life Settlements

Despite confusion among life settlement providers, the IRS has not clarified the tax implications of life insurance policies sold as a life settlement in the secondary market. Consequently, they advise their clients to seek advice from a professional tax advisor. However, tax professionals may not be able to properly advise their clients on their tax liabilities given the lack of clarification by the IRS about life settlement transactions.

According to the Congressional Research Service (CRS), there are several interpretations of the tax code and regulation for such transactions.¹⁶ CRS noted while there are varying interpretations of the tax consequences of these transactions, that in all cases normal penalties would apply for underreporting of income if the income is not reported.

In December 2007, the Department of the Treasury responded to an inquiry from Congressman Richard E. Neal, Chairman of the Subcommittee on Select Revenue Measures of the Committee on Ways and Means, addressing the tax treatment of life settlement transactions. The letter stated that the Treasury was “working closely with the Internal Revenue Service on how best to address these transactions.” However, the Committee found that no action has been taken to date.

Committee Action: On April 6, 2009, Chairman Kohl sent a letter to the Department of the Treasury Secretary, Timothy Geithner, requesting that the Secretary direct the IRS Commissioner to take immediate action to clarify the tax treatment of life settlement transactions for both consumers and investors.

Secretary Geithner responded on April 27, 2009, noting that the Department of the Treasury and the IRS are taking deliberate steps to complete needed guidance, and expects that it will be published in the Internal Revenue Bulletin soon. (See Appendix I for the Department of the Treasury response letter.)

Most State Securities Regulators and the Securities and Exchange Commission Consider Life Settlement Investments to be Securities

Most states have an oversight structure for settlement products resulting from market abuses in the 1980s. Such products are regulated either through their respective insurance departments, securities departments, or some combination of both. While these oversight structures vary across states, as of

¹⁵ Rybka, L., Schick, B. & Teitelbaum (2008). *Hybrid Premium Financing- Is There a Right Way?* Presented at the 2008 LIMRA Conference.

¹⁶ According to CRS, the proceeds received for participating in a life settlement transaction may be considered ordinary income and taxed at the personal income tax rate of as high as 35 percent. An alternative interpretation suggests that a life settlement transaction could be taxed at capital gain tax rates, generally at 15 percent. In the case of stranger-originated life insurance (STOLI), under either interpretation, any forgiven nonrecourse loan amount would be taxable as ordinary income. In addition, insurance premiums not paid by the insured and/or promotional gift received may be treated as ordinary income. (CRS. Memorandum to Special Committee on Aging, Life Settlement/Vitiation of Life Insurance Policies, Including Stranger-Originated Life Insurance (STOLI). April 2, 2009.)

October 2007, 46 states and the District of Columbia had statutes regulating the purchase and investment of viatical or life settlements as securities transactions. Accordingly, several state securities regulators have recently taken action against life settlement providers and brokers operating in their specific states.¹⁷ For instance, in 2008, the Denver District Court ruled in favor of the Colorado Securities Commissioner that Life Partners, a large life settlements provider, violated Colorado securities law by selling unregistered life settlements in Colorado without a proper license.

Most states (46 states and the District of Columbia) and the Financial Industry Regulatory Authority (FINRA)¹⁸ consider life settlements to be securities. In August 2006, FINRA issued guidance on life settlements stating that a variable life insurance policy is a security and the sale of such a product in the secondary market is a securities transaction subject to its rules. While the Securities and Exchange Commission may assert oversight on a case-by-case, it has yet to formulate a formal position on the extent to which life settlement brokers and providers should be registered with the SEC.¹⁹

Committee Action: On April 6, 2009, Chairman Kohl sent a letter to Chairman Mary Schapiro of the Securities and Exchange Commission urging her to evaluate the extent to which life settlement brokers and providers should register and disclose their activities to the Commission.

Chairman Schapiro responded on April 28, 2009, noting that the SEC “will look carefully at the issues surrounding the registration of life settlement providers and brokers and the potential need to regulate more specifically in this area.” (See Appendix II for the SEC response letter.)

She also clarified the Commission’s jurisdiction stating that “a life settlement arrangement is typically comprised of two types of transactions: a sale by an individual owner of his or her life insurance policy, and a purchase by an investor of an interest in the policy or in a securitized pool of such policies. The sale of a life policy by its owner would involve a securities transaction subject to the Commission’s jurisdiction in at least two circumstances. If the policy itself is a security (typically, a variable life insurance policy), that fact alone would bring the transaction under federal securities laws. Second, regardless of whether the policy itself is a security (and many life insurance policies are not), if the owner sold the policy in order to purchase securities with the proceeds, the sale could come under the Commission’s jurisdiction.

The second part of the transaction—the purchase of an interest in the life insurance policy or a pool of policies—can be structured in a variety of ways, but in many cases, this transaction will involve the sale of a security and thus be subject to the Commission’s jurisdiction.”

States are Taking Action to Increase Transparency in the Life Settlements Market, but Actions Lack Consistency

Although most state insurance codes contain provisions that address life settlement transactions, these regulations vary widely. For example, some states only impose licensing requirements for agents/brokers while others may also include reporting and privacy requirements, advertising and marketing regulations, and require certain disclosures be made to policy owners (consumers) or the

¹⁷ State securities regulators taking action against life settlement providers include regulators from Alabama, Colorado, Hawaii, New York, North Carolina, and Wisconsin.

¹⁸ NASD v. Fergus et al., Complaint No. C8A990026 (May 17, 2001) (NASD Enforcement Action).

¹⁹ SEC v. Mutual Benefit Corps., 403F. 3d 737 (11th Cir. 2005).

affected insurer(s). Some states also impose varying penalties for failure to comply with statutory requirements: there may be either civil or criminal monetary penalties, prison sentences, or both; while some state viatical/life settlement statutes consider violations of their viatical/life settlement provisions to be violations of the state's "unfair practices" law, to be punished according to the penalty provisions, if any, of that respective law.

The National Association of Insurance Commissioners (NAIC) and the National Conference of Insurance Legislators (NCOIL) have model legislation addressing life settlements.²⁰ In addition to enhancing licensing regulations and disclosure provisions, the NAIC and NCOIL model acts address the issue of STOLI—the NAIC Model Act establishes a five-year moratorium on the settlement of policies having STOLI characteristics while the NCOIL model instead defines and bans STOLI practices.

Committee Action: The Committee will consider the extent to which significant consumer protection legislation is needed to address the inconsistency in state regulation of life settlements.

²⁰ The NAIC's *Viatical Settlements Model Act* was amended in June of 2007. NCOIL's *Life Insurance Settlements Model Act* was approved by NCOIL in November of 2007.

Appendix I: Response from the Department of the Treasury



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

April 27, 2009

The Honorable Herb Kohl
Chairman
Special Committee on Aging
United States Senate
Washington, DC 20510

Dear Chairman Kohl:

Thank you for your letter regarding the tax consequences to individuals who sell, and investors who buy, life insurance policies in the secondary market. We share your interest in these important issues and have been working on guidance to address them.

Given the importance of these issues, the Department of the Treasury and the Internal Revenue Service are taking deliberate steps to complete needed guidance. At this point, we expect that guidance will be published in the Internal Revenue Bulletin soon. We appreciate your interest in this important matter.

Sincerely,



Timothy P. Geithner

Appendix II: Response from the Securities and Exchange Commission



THE CHAIRMAN

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

April 28, 2009

The Honorable Herb Kohl
Chairman
Special Committee on Aging
United States Senate
Washington, DC 20510-6400

Dear Chairman Kohl:

Thank you for your letter of April 6, 2009 regarding the secondary market in life insurance policies, the so-called life settlement market. In your letter, you express concern regarding the level of transparency in the market, the regulatory approach to the transactions involved, and potential risks for seniors who sell their policies in the secondary market and for seniors and others who invest in life settlements.

I share your commitment to the protection of seniors and appreciate your concern that seniors be treated fairly in the marketplace and have access to accurate and unbiased information related to their investments. Transparency of the information needed to make informed investment decisions is the cornerstone of the federal securities laws. Life insurance is a crucial asset to many of America's seniors, which can be an important source of funds needed for current living expenses or a means to provide for their family members upon death. A decision to sell a life insurance policy is an important financial decision, and a senior (or any investor) that is involved in any life settlement transaction that constitutes a securities transaction, either as a seller of a life insurance policy or as an investor, is entitled to the full protection of the federal securities laws. These include required disclosures, suitability requirements applicable to broker-dealers, and antifraud protections.

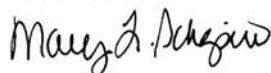
As you know, a life settlement arrangement is typically comprised of two types of transactions: a sale by an individual owner -- often a senior citizen -- of his or her life insurance policy, and a purchase by an investor of an interest in the policy or in a securitized pool of such policies. The sale of the life policy by its owner would involve a securities transaction subject to the Commission's jurisdiction in at least two circumstances. If the policy itself is a security (typically, a variable life insurance policy), that fact alone would bring the transaction under the federal securities laws. Second, regardless of whether the policy itself is a security (and many life insurance policies are not), if the owner sold the policy in order to purchase securities with the proceeds, the sale could come under the Commission's jurisdiction.

The Honorable Herb Kohl
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The second part of the transaction – the purchase of an interest in the life insurance policy or a pool of policies - can be structured in a variety of ways, but in many cases this transaction will involve the sale of a security and thus be subject to the Commission’s jurisdiction. The federal securities laws apply to “investment contracts,” a term which is broadly defined by the courts and the Commission to include an investment of money in a common enterprise with the expectation of profit from the efforts of a promoter or a third party. Typically, the management activities and services provided by the party who arranges the life settlement and sells the interest to an investor will bring the transaction within the definition of an “investment contract.” The Commission has brought enforcement actions against persons who sold similarly structured products called “viatical settlements” to investors. In one early Commission case in this area, the court concluded that the viatical settlements at issue were not securities, *SEC v. Life Partners*, 87 F.3d 536 (D.C. Cir. 1996); however, the Commission has continued to bring cases in this area, and the most recent appellate decision on the issue, *SEC v. Mutual Benefits Corp.*, 408 F.3d 737 (11th Cir. 2005), agreed that viatical settlements were securities subject to the federal securities laws. Nonetheless, we will look carefully at the issues surrounding the registration of life settlement providers and brokers and the potential need to regulate more specifically in this area.

I greatly appreciate your interest in this matter, and please don’t hesitate to contact me at (202) 551-2100, or have your staff call William Schulz, Director of Legislative and Intergovernmental Affairs, at (202) 551-2010 should you need additional information. I look forward to working with you and the Committee in the coming months on this and other matters towards our common goal of protecting seniors.

Sincerely,



Mary L. Schapiro
Chairman