Emerging Regulation of Life Settlements Aims to Protect Consumers

by Larry Simon and Greg Schmitt

As clients weigh life settlements as an option in serving long-term financial needs, agents and brokers will be faced with myriad questions about the laws surrounding this evolving industry. It is imperative for life settlement brokers and agents to understand state regulation of the secondary market since they add credibility to the industry and protect the consumer.

The life settlement market has grown from zero in the mid-1990s to around $13 billion today, according to a June 2005 Bernstein Research report. Bernstein Research projects that the market will grow to $160 billion over the next several years. Along with this industry growth, will come an increase in state and federal regulation.

The Current State of Regulation

The authors of the Bernstein report expect regulatory issues to crop up over coming years as the life settlement industry receives more attention, but they do not foresee it hurting the industry's long-term prospects. According to the report, 36 states have some form of regulation for viatical or life settlements, including minimum payouts (as a percentage of face value) in some states. About 15 states allow agents with standard life insurance licenses to negotiate life settlements on behalf of clients. The authors of the Bernstein report contend the lack of licensing in other states does not prevent life settlements from taking place. But, it could give rise to poor-quality transactions that may or may not benefit policyholders. Another issue is whether underwriters need to be registered with insurance regulators, which varies by state, according to the report.

As the need for regulation of the life settlement industry progresses, the nation's leading life settlement companies are voicing their support for anti-fraud laws, which would help curtail abuses by disreputable firms and inspire public confidence in and demand for the services, according to an October 2002 paper published by the Wharton Financial Institutions Center.

Legislators and Regulators are Addressing Issues

The following issues are receiving the attention of legislators and regulators throughout the country:

- **Facilitating change of policy domicile may be viewed as fraudulent** – Effective July 1, 2005, Florida amended its viatical/life settlement laws to make it a crime, (punishable as a felony) to change ownership of a policy or change residency of a seller to avoid the state's regulation. For example, an agent who is not licensed in Florida may not suggest to a Florida policy holder that a policy should be transferred to a related party in another state before selling the policy, if it is done to avoid Florida licensing laws. Other states are also considering similar laws.
- **Insurer disclosure proposals** – Some states are circulating proposals that would require insurance carriers to provide written notice to certain policy owners about the advantages that might be offered through a settlement transaction.
- **Broker commission disclosures** – More states will be moving toward requiring disclosure of the amount and method of calculation of commissions paid to settlement brokers and agents in connection with settlement transactions. Some brokers oppose such requirements because they say it would interfere with the ability of honest brokers to compete against others who may not fully comply with such laws. The primary argument in favor of such disclosure is that it is consistent with the concept that the broker/ agent acts as the seller's fiduciary representative and fiduciaries have long been held to a high standard of full disclosure.
- **What is "insurable interest" and why does it matter?** – The legal concept of an "insurable interest" is based on the question of what the policy owner stands to lose upon the insured's death (not what the policy owner will gain through recovery on the policy). Insurable interest is determined by the relationship among the insured and the original owner and beneficiaries of the policy (as measured at the time the policy is issued). The lack of an insurable interest at the policy inception renders a policy void. Spouses, dependents, and other close family members are presumed to have an insurable interest based on their relationships with the insured. Business entities must show that the insured is a "key person" in the operation of a business enterprise and that the loss of that person would have an adverse economic impact on the company. This even applies to family-owned companies or family partnerships. The policy carrier can often assert an insurable interest defense any time during the policy term or even after the insured's death. Legislators in various states are expected to continue ongoing discussions of expanding or contracting insurable interest rules.

A terrific resource to research up-to-date state statutes, key definitions, regulations, and disclosures can be found on the "settlement requirements" page of the Life Insurance Settlement Association's Web site, located at www.lisassociation.org.

National Association of Insurance Commissioners Viatical Settlements Model Act

For years, leaders in the life settlement industry have worked for consistent regulation of life settlements along with the National Association of Insurance Commissioners (NAIC). The NAIC is a voluntary organization composed of insurance regulatory officials from all states. In 1992, the NAIC developed the Viatical Settlements Model Act, which would require companies and brokers to obtain a license before entering into viatical settlement agreements. Several states have adopted the model act and others have implemented certain provisions of the act in enacting regulations.

In June 2004, the NAIC published a model regulation for viatical and life settlements. Under the model regulation, licensed life insurance agents who recommend settlements would not need a separate settlement broker's license, thus making it easier for them to advise clients about life settlements. At the same time, the National Council of Insurance Legislators supported similar efforts to not require separate licenses.

The current version of the NAIC model act broadens the definition of viaticals to include any sale of a life insurance policy, including life settlements. It also includes clauses protecting against fraud and gives states the option of addressing sales to investors. While the NAIC recommendations are not law, they were developed to encourage states to adopt uniform standards to regulate the evolving life settlement industry. Legislation based on the model act is pending in California, Illinois, New York and South Carolina, among other states.

California Regulation

In 2003, the California Department of Insurance (CDI) sponsored a bill to expand the state's viatical laws to include life settlements. At the time, CDI contended that, even though they are not called "viaticals," life settlements may legally be viatical settlements under the California Insurance Code, putting them under CDI's regulatory authority. Many in the life settlement industry argued that any regulation of these transactions should be based on the NAIC Model Act since a life settlement is a unique product. The CDI's 2003 proposal was not enacted, but discussions of expanded regulation have continued in California.

In 2005, California Assemblyman Juan Vargas, chairman of the Assembly Insurance Committee, introduced A.B. 243, which aims to increase issuance and renewal fees for viatical licenses and provides for regulation of life settlements in California. It is based, in large part, on the NAIC Model Act. A.B. 243 which would expand existing laws to include provisions governing life settlements, but leave California's current viatical statute intact for transactions involving people with catastrophic or life-threatening illnesses or conditions. A.B. 243 includes new definitions to establish when the purchase or assignment of a life insurance policy qualifies as a life settlement rather than a viatical settlement. A recent amendment would eliminate the requirement for the producer to disclose to the seller the last (highest) offer received from each life settlement provider that bid on the policy – an amendment that seems contrary to the public interest and likely to spawn further debate on broker disclosure obligations.

Finding the Right Life Settlement Company

Since state-by-state regulation of life settlements varies, agents and brokers need to be aware of existing laws governing the sale of life insurance policies in the secondary market. When required, they should work only with licensed life settlement providers. Regardless of whether a state regulates life settlements, agents and brokers should perform due diligence by gathering information from several competitive companies. They should choose those with the most experience; best resources; best reputation; and an excellent senior management team with the most life settlement, life insurance, legal, and investment banking experience.

Here are some guidelines to help agents and brokers make the right choices for their clients:

- Solicit bids only from experienced and ethical providers.
- Select a life settlement company that is licensed or otherwise qualified to do business in the state in which the policy holder resides.
- Look for proven industry experience, preferably at least $1 billion in purchased aggregate face value to date.
- Confirm that the company is institutionally funded and will not re-sell the contract to an individual investor.
- Check with the state attorney general's office or state insurance department for any complaints or legal action against the settlement provider.
- Make sure clients consult with professional tax advisers. ❑

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