E&O Newsletter

CITA Insurance Services

Brown & Brown of California, Inc.
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SELLING VIATICALS THE GAMBLE OF A LIFETIME

Lack of consistent regulatory control due to the ambiguity of these investments has paved the way for much of the industry's unlawful activity. Regulations vary dramatically from state to state, likely adding fuel to the fire. Federal regulators have ruled viaticals to be insurance products, yet several states consider them to be securities.

If you choose to sell viatical settlements, you should determine whether your state considers them to be securities, and which licenses are required to sell them. As with any product, you should also check with your broker-dealer to see if a particular viatical product is approved for sale. Even with proper approval, your E & O policy may not cover these transactions, leaving you at even greater risk.

Full Disclosure Is Imperative [1]

If you wish to transact business in this area despite the risks, you will want to be sure your clients know exactly what they are getting into. There are many misconceptions about viatical settlements that can lead to problems for clients down the road. As their agent, you're the first one they will point the finger at when something goes awry. To help alleviate this risk, here are some important points to be mindful of when selling viatical settlements:

1) **They are not liquid investments**. Once purchased, there is not generally a secondary market. The client's money is locked up as long as the viator continues to live.

2) **They do not have fixed maturity dates.** The investment "matures" when the viator dies, and regardless of ones age or diagnosis, there is no guarantee of when someone will die.

3) **The rate of return is uncertain.** No one should quote a rate of return because it depends solely on when the viator dies. Projected rates of return based on an expected number of years until death are misleading, and create false expectations.

4) **The status of the policy may be difficult to ascertain.** If the viatical settlement company is responsible for maintaining the policy, there should be a means of insuring that they are making the necessary premium payments and that they will renew the policy as needed in the case of a term policy.

If your clients are looking to bet on the life of another, or put their own policy up for sale, it is wise to consider not only the risks to them, but also the gamble you could be taking in terms of your career.

Often promoted for their low risks and high potential returns, some agents have found viatical settlements to be a profitable business and an attractive investment for clients. In fact, since their inception in the 80's, viaticals have grown to a $2.5 billion industry, and are projected to exceed $10 billion by the end of 2007. Yet these investments are complex and the risks profuse, often leading to costly problems for all involved. Before treading through the convoluted world of viatical settlements, there is much you should know to protect yourself and your client.

A Troubled Industry

While a viatical settlement is a legitimate investment vehicle that may be suitable for some clients, the industry has been plagued by fraudulent transactions and deceptive practices that could ultimately mean trouble for agents.

Throughout its short history, the viatical industry has experienced over 40 civil and criminal investigations. More than 75 individuals have been convicted. In January, the North American Securities Administrators Association (NASAA) listed viaticals among the top 10 consumer securities complaints of 2003. Viaticals are also mentioned on NASAA's Top 10 Scams, Schemes and Scandals for 2004. In another ranking by the California Department of Corporations Top 10 investment schemes for 2004, viaticals rank 8th in terms of prevalence and gravity while insurance agent securities fraud, which included viaticals, ranked 1st.

Accusations range from selling nonexistent insurance policies and making guarantees of inflated rates of return, to well-orchestrated schemes such as clean sheeting, where an individual with health problems obtains a life insurance policy without disclosing their condition. Then they sell the policy to a viatical company, who later sells it to an investor. The investor risks losing their money when the insurance company finds out about the policyholder's poor health and cancels the policy.

What are Viatical Settlements?

Viatical settlements, sometimes referred to as life settlements or senior settlements, involve the sale of an existing life insurance policy to a third party, typically for an amount somewhere between the cash value and the death benefit. The life insurance holder ("viator") typically sells their policy due to terminal illness, change of needs or lack of financial means to continue paying the premiums. The money earned from the sale is often used to pay for medical expenses or long-term care.

5) **The policy may be contested.** You should determine whether the policy has a contestability clause that could enable the insurance company to deny the claim. Payment may be denied for a number of reasons including suicide, suspected murder by an interested party, or even discovery of false information on the viator's application. If family members decide to contest the viatical settlement, payment could be delayed.

6) **One of the parties could go out of business**. There is always a chance that either the life insurance company or the viatical settlement company may go out of business, leaving your client in the lurch.

7) **The policy may be fraudulent**. Due diligence efforts should help to thwart this risk however, due to the nature of the industry, there is always the chance that the viator obtained a policy in a fraudulent manner, or that the viatical settlement company is illegally offering the policy. There have even been cases where viators have sold the same policy more than once.

Assessing Suitability for Investors

Due to their level of complexity and risk, viatical settlements are generally not appropriate for the average investor. In fact, even your most sophisticated client with a high tolerance for risk should think twice. Here's why:

1) **When there's death, there are taxes**. While both are certain, their timing is not. Clients who invest in viatical settlements should be aware that, unlike other investments, they have no control over when they receive the payoff, which could seriously impact their tax situation in any given year. Furthermore, the proceeds are typically not considered to be a capital gain and will generally be taxed as ordinary income.

2) **The payoff is uncertain**. As discussed above, there are no guarantees that a policy will pay off within a particular time frame. There is even the potential that the viator could outlive the investor. Thus your client should be an experienced investor who is in a position to accept a high level of risk. If they will be dependent upon their funds at some future date, say to help fund living expenses during retirement, this may not be the investment for them.

3) **Your client may be responsible for future premiums**. If a viator lives beyond the expected date of death, the viatical settlement company may require the investor to pick up the premiums.

4) **A viatical settlement is not an appropriate investment for an IRA**. Serious IRS penalties may apply when IRA funds are used to purchase life insurance contracts, although there are some loopholes due to the convoluted classification of certain viatical products (some are marketed as securities rather than life insurance products). Even so, your client could face stiff penalties if they are unable to take their mandatory distribution at age 70 ½ due to the illiquidity of a viatical settlement in their IRA.

Assessing Suitability for the Viator

Suitability is a two way street with viatical settlements. Clients who sell their policies need to have a clear idea of what they are doing and how this will impact them down the road. Initially, viatical settlements became popular in the early 80's as a means for AIDS patients, many who were diagnosed as terminally ill, to obtain money for medical care. However, as new drugs were quickly developed, those with AIDS began living longer and investors began to lose out. Viatical settlement companies began looking for new viators, such as seniors with policies that were no longer needed or that they could no longer afford. Here are some considerations to discuss with your client before agreeing to assist them with the sale of a policy:

1) **No death, but still taxes**. There are tax consequences on both ends of the deal. If you assist a client with the sale of their life insurance policy, they should be aware that the income they receive for the sale of their policy, above their basis, is generally taxable, although some exemptions may apply for those who are terminally ill with a life expectancy of two years or less. Clients should contact their tax advisors to ascertain the impact on their personal tax situations.

2) **Their life is on the line**. Your client should be aware of the privacy issues surrounding the sale of their life insurance policy. Who will have access to their information? Will they be required to provide ongoing medical information? Are they comfortable with the whole concept of a stranger having a financial interest in their death?

3) **There may be better alternatives**. The most important issue to discuss with your client is the reason for the sale, and whether it is absolutely the best alternative for their financial situation. If they are having difficulty paying the premiums, there may be other assets they could use to generate the necessary income. If they need a lump sum, explore other means for them to obtain funds such as home equity, retirement plans, a loan against the policy, or even loans from family members. Also, their insurance policy might offer accelerated death benefits, allowing them to receive an early distribution of a percentage of their benefit amount.

Is There a Future in Death?

With our aging nation's 35 million senior citizens, and an estimated $500 billion in life insurance in force among Americans over 65, there is a vast marketplace of both prospective viators and investors. Some of these seniors suffered significant losses in the market downturn and yet are at or near retirement. That combined with record low interest rates and rising medical costs have put many in financial straits, making them more susceptible to fraud.

As a financial professional, it is your duty to protect your clients from unsavory investments through education, diligence and care. Due to the nature of the industry, if you deal in the viatical arena, there is a chance that you could unwittingly get caught up with a rogue company, thus tarnishing your reputation and endangering your career. By simply offering a product such as viaticals, you may be putting your integrity on the line among clients who may be familiar with the ills of the industry.

Regardless of their bad rap, viaticals do serve a purpose and can be a viable option for the right client. Fortunately, several states are actively pursuing regulatory changes, and the National Association of Insurance Commissioners has implemented a model law for states outlining heavier restrictions.

It will require stiffer regulation of viaticals and increased cross-regulatory coordination to continue combating viatical fraud. Until the industry can be cleaned up, extra caution is in order if you choose to deal in the viatical settlement arena

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(1) "Senior Settlements To sell or Not to Sell," by Jerome R. Corsi, Ph.d., www.TheUSBroker.com, October 2002.

(2) "California Dept. of Corporations issues Subpoenas for Information on Fraudulent Sale of Death Benefit Investments," Businesswire.com, March 8, 2004.

(3) "Suit Seeks to Recover Losses from Insurance Scam," Akron Beacon Journal, Associated Press, March 15, 2004.

Don't Let this Happen to Your Clients

In a recent case, a California woman was sentenced to almost 30 years in state prison for defrauding nearly 200 investors of more than $40 million in a scheme that involved fraudulent death benefit investments. Currently five additional companies are under investigation in California and Nevada for suspicion of illegal selling of viaticals in the state of California.

In Florida, the[2] founder of a viatical settlement firm and seven others were recently indicted on fraud and money laundering charges. The alleged $20 million scheme has affected some 4,000 investors, primarily in Florida and Ohio, who purchased life insurance policies of supposed "terminally ill" individuals. Most of the viators haven't died due to an alleged sham involving the statement of false life expectancies. Many of the investors are senior citizens who invested their life savings, expecting[3] to receive it back in a short period with sizeable returns.

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