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Viatical Settlements

*76 AGGRESSIVE VIATICAL SETTLEMENT TRANSACTIONS: GAMBLING ON HUMAN LIVES

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Aggressive viatical settlements, known as 'wet-ink' transactions, arguably appear to be illegal and invalid. Although the law is not entirely clear, it is possible that the insurance policy or the assignment of the policy may be void.

Given the recent developments in the viatical settlement industry, one might think that life insurance has gone the way of Las Vegas. People are literally gambling on human lives, rolling the dice on a viatical industry-created crap table. The allure of these high-money investments combined with the lack of rules and regulations in the area has fostered a situation in which transactions that may be invalid, fraudulent, and outright illegal (referred to as "wet-ink" transactions) are being promoted.

The main thrust of these so-called wet-ink transactions involves an otherwise healthy person purchasing a life insurance policy solely for the purpose of resale to a third party. Wealthy, older clients have been approached by insurance agents promising to pay them upwards of $25,000-35,000 per $1 million of coverage, which the insurance agents place and then arrange immediately to sell. Considering the long-standing precedent of the U.S. Supreme Court and recent reactions by federal regulators, investors as well as viatical companies should be quite wary of entering into such extreme arrangements.

Changes in the viatical industry

The viatical settlement industry initially developed in the late 1980s in response to the AIDS epidemic which began sweeping across the United States. [FN1] The first viatical settlement company purchased its first life insurance policy in 1989. [FN2] The word "viatical" comes from the Latin root "viaticum," which means provisions or supplies for a journey. [FN3] In its ecclesiastical meaning, viaticum means "as given to a dying person or one in danger of death."

In an ordinary viatical settlement transaction, a viatical settlement broker negotiates the deal in which the insured-seller (sometimes known as the "viator") sells or assigns an existing life insurance policy to the viatical settlement provider in exchange for a cash settlement amount (generally equal to 50%-80% of the face value of the policy). Essentially, the viator receives cash, the broker gets a commission, and the viatical settlement provider holds and maintains the policy until the insured's death and then collects the insurance proceeds. The viatical settlement provider will usually find an investor to provide the settlement amount and will then pay the proceeds to the investor upon the insured's death. Generally, this was an attractive investment alternative because the investor could expect a significant, low-risk return and the viatical settlement provider would guarantee maintenance of the policy's insurance coverage, paying the premiums through use of escrow accounts.

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Viatical settlements such as these even provided a public service by *77 allowing a critically ill individual to "tap into" or use up to 50%-80% of the death benefit on his or her life insurance at the end stages of life to alleviate economic hardships. Especially in the case of many younger, sickly AIDS patients, these types of viatical settlements frequently provided a vital source of funds to pursue medical treatment, maintain a home, or pay for other support needs.

Over the years, however, the viatical process became a bit more complicated. Medical breakthroughs made life expectancies harder to predict. Viatical settlement providers began making the investors responsible for paying premiums and maintaining the policies. These developments made viatical investments less attractive because the investment risk was increasing while the rate of return was decreasing. As more and more viatical companies were formed, the industry gravitated in different directions, with several companies seeking new ways to attract investors. In recent years, these companies, taking advantage of the lack of rules and regulations in the industry, have been pushing the envelope of reasonableness and luring large amounts of dollars from unwary investors.

The Viatical Association of America says that $1 billion worth of coverage came into the market last year alone. [FN4] And with all those dollars has come considerable fraud. [FN5] According to Roger Walter, general counsel for the Kansas securities commissioner and chairman of a viaticals task force with the North American Securities Administrators Association, "[s]o many people are in these things, we don't even know how much has been sold. And because this has been to a large extent outside regulation, a lot of fraud has poured into the market." [FN6] "It's a totally unregulated market," says Joseph M. Belth, editor of The Insurance Forum newsletter; "[t]here are no standards, no rules, and [the viatical companies] can do anything they want. You talk about your cowboys out there; this is a totally unregulated market, and it's open season." [FN7]

Creation of the 'wet-ink' transaction

Recently, viatical companies have moved farther down the slippery slope, with their entry into the realm of so-called wet-ink transactions, which are arguably the most obvious cases of fraud in the industry. [FN8] In these extreme cases, viatical companies are recruiting all types of people (old and young, sick and healthy) to purchase life insurance policies solely for resale. The transaction is fraught with misconduct at all angles. The insured receives a lump-sum payoff equal to a percentage of the face amount of the policy (in most cases, up to 3.5%) and will sometimes make misleading statements regarding health status in applying for the policy. [FN9] The insurance agent and/or viatical company receive (or split) the commission for formulating the transaction, and the investor seeks to cash in on the proceeds via a premature, unforseen death of the insured. [FN10]

Overall, the viatical company (at times, through the actions of licensed insurance agents) has effected a transaction in which a life insurance policy is held by a third-party investor on the life of a complete stranger. The investor has no personal interest in the life of the insured, but instead has a tangible incentive in the insured's quick and early demise. In essence, the investor is akin to a casino "player" gambling on death, hoping it will come soon enough to yield a sufficient return on the investment. The viatical companies are the "dealers," and they have been aggressive and eager to promote their objectives. The main problem, however, is that these transactions appear--at least arguably--to be illegal and invalid. As a result, an investor may "crap out" and have *78 no right to recover any proceeds upon the death of the insured.

'Wet-ink' transactions may be illegal

One day, an insurance company or perhaps a regulator may argue that the third-party investor had no insurable interest in the insured, and thus the policy could not have been issued; it was illegal and therefore void from the outset. They may argue that the only reason the policy was issued was due to a fraud perpetrated by the insured in conjunction with his insurance agent and/or the viatical settlement entity. The fraud would be the insured's executing the insurance application for a policy on his own life even though he had no intention of maintaining the policy and had, in fact, prearranged to sell it. Long-standing U.S. Supreme Court precedent, discussed below, seems to support this argument.

Another argument may be that the contract is not void, but rather only its assignment is void. In that case, the original insured's estate may have a claim to the death benefit.

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Supporters of "wet-ink" viatical arrangements will no doubt assert that so long as the insured applies for a policy on his own life, then at the moment of issuance there is an owner (the insured) with an insurable interest, and, they'd argue, that's all that matters. Selling the policy 30 or 60 days later is not illegal, they're likely to defend. However, the law is not so clear. If either of the countervailing arguments succeeds, no one can be sure what exactly will happen--except to say that some or all of the parties to the transaction may wind up harmed.

U.S. Supreme Court sets the precedent

If the owner of a life insurance policy assigns the policy to a person without an insurable interest, and the motive for the assignment is merely to circumvent the law (such as where there was a preconceived agreement that the policy would be assigned), such assignment will not be upheld. [FN11] In Warnock v. Davis, [FN12] the Supreme Court stated that the assignment of a life insurance contract to a person without an insurable interest makes the contract "a mere wager, by which the party taking the policy is directly interested in the early death of the [insured]. Such policies have a tendency to create a desire for the event. They are, therefore, independently of any statute on the subject, condemned, as being against public policy."

The Supreme Court qualified this rule somewhat, in Grigsby v. Russell, [FN13] by holding that a life insurance policy taken out in good faith by the insured--with no preconceived notion of assignment--can later be sold and assigned, in good faith and for valuable consideration, to a person who does not have an insurable interest in the life of the insured. [FN14] Acting in "good faith" is essential. As the court in Grigsby stated, "cases in which a person having an interest lends himself to one without any, as a cloak to what is, in its inception, a wager, have no similarity to those where an honest contract is sold in good faith." [FN15]

Accordingly, the validity of the assignment depends on the parties' motive at the time the insurance contract was procured. It is clear that assignments of life insurance policies that occur contemporaneously with the issuance of the policies will be considered wagering contracts and thus invalid. [FN16] The court in Steinback v. Diepenbrock [FN17] stated, "[t]he insured, instead of taking out a policy payable to a person having no insurable interest in his life, can take it out to himself, and at once assign it to such person. But such an attempt would not prove successful, for a policy issued and assigned under such circumstances, would be none the less a wagering policy, because of the form of it. The intention of the parties procuring the policy would determine its character, which the court would unhesitatingly declare in accordance with the facts, reading the policy and the assignment together, as forming part of one transaction." [FN18]

Further, if the facts indicate even a presumption of wagering intent, the assignment will be avoided. [FN19] "Any contract, the tendency of which is to endanger the public interest and affect the public good, and which is subversive of sound morality, ought never to receive the sanction of a court of equity or be the foundation for its judgment." [FN20]

Effect of finding the 'wet-ink' viatical illegal

With respect to the policy itself, some jurisdictions have held that a wagering assignment of a policy renders it void, despite the fact that it may have been valid at its inception. [FN21] Generally, though, an assignment done with wagering intent, which is declared invalid and unenforceable, will not render ***79** the policy void, so as to preclude recovery by the insured's estate. [FN22] Indeed, the personal representative may be able to recover the policy proceeds by virtue of the decedent-insured's original title to the policy. [FN23] Hence, when the insured dies, his estate may have an enforceable claim to the death benefit even though the insured sold the policy. If that happens, the viatical settlement provider may only have a claim to recover any payments made to the insured.

Based on the above analysis, it appears that these "wet-ink" transactions would raise serious suspicion as to their intent and validity. If insurance policies are being purchased with the intent of immediately attempting to sell them to third parties without an insurable interest, then such transactions are in conflict with the rationale and holdings of the Supreme Court set forth almost a century ago.

Purchasing a life insurance policy merely for the purpose of obtaining pecuniary gain by assigning the policy to a

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party without an insurable interest would likely be characterized as a wagering contract. Such an assignment would be invalidated, and the contract itself could be declared void. Alternatively, as noted above, the insured's estate may have a claim to the death benefit-- leaving the investor with nothing more than a claim against the estate to be reimbursed for the initial payment to the decedent-insured and/or any premiums paid (perhaps with interest). In any case, an investor likely would not be entitled to receive the policy proceeds upon the insured's death, causing the investor to lose his entire investment return.

Insurance companies react to the problem

Joseph Belth likely would agree with the foregoing and has said that these types of deals in the market are probably cases of "outright fraud." [FN24] Some insurers have recognized the problem, too. Columbian Mutual Life Insurance Co., Binghamton, NY, recently terminated an agent's contract and rescinded several policies issued pursuant to a "wet-ink" scam. [FN25] Prudential Insurance Co. of America, Newark, NJ, has advised its policyholders to exercise caution in viaticating their policies, while Northwestern Mutual Life Insurance Co., Milwaukee, prohibits its agents from receiving commissions for such transactions. [FN26] Joel Seigle, Vice President of life product development and support for Transamerica Life Co., Los Angeles, has stated, "[w]ith respect to the narrow subset of viatical settlements known as 'wet-ink' viaticals, our company position is that we will not participate in these transactions until there is clarity on the regulatory front." [FN27]

Federal regulators review the issue

Regulatory guidance is needed, and the viatical settlement industry regulators are attempting to provide it. The National Association of Insurance Commissioners (NAIC) has had a working group focusing on viatical settlements since 1992. [FN28] A model act has been in place since 1993. [FN29] The working group submits its suggestions and proposals to its parent committee, the Life and Annuity Committee, and, ultimately, they are reviewed by the NAIC Executive Committee for final approval. This year, the working group has been assigned the task of analyzing and evaluating these "wet-ink" transactions. According to Lester Dunlap, the chairman of the working group, the group will address several issues, including who is brokering the transactions, who the investors are, and whether there should be suitability and/or licensing requirements. [FN30] Dunlap claims, "[the need for review] is driven by concerns that some undesirable elements could get involved...." [FN31]

Investors, be wary

A number of problems and concerns exist regarding the use of "wet-ink" transactions as investment vehicles, although we believe viatical companies and/or some insurance agents continue to aggressively promote these types of transactions to potential investors. Potential investors, however, should not be lured in by these companies' tactics, which, similar to the bright lights of Las Vegas, contain the empty promise of large monetary returns.

It appears that these "wet-ink" transactions are scams, lacking in validity as well as legality. The Supreme Court has held this position for over a century, declaring that life insurance polices purchased solely for resale to a third party are mere wagering contracts which are against public policy, and will be held invalid. Recently, insurance providers have recognized this problem and imposed restrictions on such transactions. In addition, viatical industry regulators have finally caught on and are working to resolve this issue. Investors, be wary. And if you still desire to "cash in" on the crap table of human lives, perhaps you should go to Las Vegas instead.

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[FN1]. Crites-Leoni and Chen, "Money for Life: Regulating the Viatical Settlement Industry," 18 J. Legal Med. 63 (March 1997).

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[FN2]. Id. at 66.

[FN3]. The American Heritage Dictionary of the English Language (1969).

[FN4]. Quinn, "The Lottery on Lives," Newsweek, p. 55 (3/15/99).

[FN5]. Panko, "Playing the Death Pool," Best's Rev.--Life-Health Ins. Edition (4/1/99).

[FN6]. Id.

[FN7]. Id.

[FN8]. Id.

[FN9]. Id.

[FN10]. Id.

[FN11]. Warnock v. Davis, 104 U.S. 775 (S.Ct., 1881); Cammack v. Lewis, 82 U.S. 643 (S.Ct., 1872); Finnie v. Walker, 257 F. 698 (CA-2, 1919) .

[FN12]. 104 U.S. 775, 779 (S.Ct., 1881).

[FN13]. 222 U.S. 149, 155 (S.Ct., 1911).

[FN14]. See also Finnie, 257 F. at 700.

[FN15]. Grigsby, 222 U.S. at 156.

[FN16]. Finnie, 257 F. at 700; see also Warnock, supra note 11, Cammack, supra note 11, and Steinback v. Diepenbrock, 158 N.Y. 24 (1899).

[FN17]. 158 N.Y. 24, 33 (1899).

[FN18]. See also Bromley's Adm'r. v. Washington Life Ins. Co., 92 S.W. 17, 18 (1906).

[FN19]. Finnie, 257 F. at 701.

[FN20]. Ritter v. Mutual Life Ins. Co., 169 U.S. 139 (S.Ct., 1898).

[FN21]. See Metropolitan Life Ins. Co. v. Elsion, 72 Kan. 199 (1905).

[FN22]. See Finnie, 257 F. at 702.

[FN23]. Id.

[FN24]. Quinn, supra note 4.

[FN25]. Panko, supra note 5.

[FN26]. Id.

[FN27]. Id.

[FN28]. Id.

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[FN29]. Id.

[FN30]. Id.

[FN31]. Id.

28 Est. Plan. 76, 2001 WL 50366 (W.G.&.L.)

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