Regulation in the Life Settlement Industry: Has the Pendulum Swung Too Far?

By James W. Maxson

The Oxford English Dictionary (2000) defines “regulate” as follows:

“To control, govern, or direct by rule or regulations; to subject to guidance or restrictions; to adapt to circumstances or surroundings.”

This definition addresses three situations: 1) the need to have regulations which originate from a central authority, such as the federal or state government; 2) the need to curtail some activities that fall outside of acceptable societal norms; and 3) the need to modify existing arrangements to address future situations or past concerns.

It is beyond debate that in order to have a successfully functioning society we must accept some form of regulation of our activities, but the balance between the right amount of regulation and too much regulation is a fine line. Arguably, recent legislative trends impacting the life settlement industry have crossed the line from promoting a vibrant and healthy market, to suppressing competition and thereby harming consumers. Specifically, as discussed below, it is not difficult to argue that the so-called “5-Year Ban,” as well as certain other provisions in the recently amended National Association of Insurance Commissioners’ Model Viatical Settlements Act, do more harm to consumers than good.

The life settlement industry has its roots in the AIDS epidemic of the late 1980s. Sufferers of the disease were considered to be terminally ill, and many needed cash for life-prolonging treatment and end-of-life expenses. These individuals found willing buyers for what was previously an illiquid asset: their life insurance policies. Initially, no laws or regulations governed the sale of a life insurance policy, and tales of abuse, both apocryphal and legitimate, soon drew the attention of state regulators. Many regulators initially looked at this new industry with skepticism, but were won over by the significant benefits offered to the residents of their respective states.

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As a society, we accept that regulation is necessary to protect consumers from inappropriate market structures as well as the imbalance of power that can arise when one party to a transaction possesses significantly more information than the other party. Due to the fragile health of many of the policy sellers involved in the first settlements, regulators appropriately decided that the imbalance of power between the parties was too great and that it was necessary to regulate the secondary market for life insurance. After some initial resistance, the overwhelming majority of the stakeholders in the settlement industry agreed and began advocating for responsible regulation.

Having no model upon which to rely, first movers, such as the States of California and New York, in 1990 and 1993, respectively, passed legislation regulating the sale of life insurance policies where the insured under the policy was terminally ill. Attempting to create a legislative template, in 1993 the National Association of Insurance Commissioners (“NAIC”) adopted its first Viatical Settlements Model Act (the “Model Act”). Since 1993, the NAIC has amended its Model Act several times, ultimately including all sales of life insurance policies, regardless of the health of the insured.

The National Conference of Insurance Legislators (“NCOIL”) promulgated its own version of a settlement act in 2000 (the “NCOIL Act”), which was significantly updated and revised in 2007. By the middle of 2008, 41 states had adopted some form of regulation over the secondary market for life insurance, most based on the NAIC Act, but several adopting the provisions of the updated NCOIL Act.

Generally speaking, the various state statutes and regulations based on both the Model Act and the NCOIL Act regulate the sale of life insurance policies, and the individuals or entities involved in these transactions in a number of ways, including, but not limited to: 1) provider and broker licensing, including, in many states, extensive background checks and fingerprinting; 2) requiring that all contracts and related documents be filed and approved; 3) requirement for annual reports; 4) restrictions on disclosing financial or medical information; 5) requiring payment through escrow accounts, and mandating time periods for funding the
escrow accounts and paying the policy owner; 6) permitting the policy owner to rescind a sales transaction for 30 days after execution of the sale agreement, or 15 days after receipt of the settlement proceeds; 7) extensive disclosure requirements; 8) minimum payment requirements for terminally ill individuals; 9) restrictions on advertising; and 10) criminal and civil penalties for violations of the laws.

Unfortunately, every state has adopted its own “spin” on the Model Act or NCOIL Act, so rather than having one set of consistent regulations with which to comply, industry stakeholders find themselves stretched across up to 41 separate jurisdictions, dealing with up to 41 separate regulatory agencies.

While the secondary market for the sale of life insurance is as heavily regulated as almost any in existence, and the costs and burdens of compliance are significant and on-going, the Model Act and NCOIL Act created a framework that provided policy sellers with rights and protections while not overburdening the settlement industry with meaningless, innovation-stifling regulation. However, in 2007, ostensibly as the result of the surge in so-called Stranger Originated Life Insurance (“STOLI”), the NAIC promulgated a new model act (the “2007 Model Act”) which contains provisions that cross the line between consumer protections and over-regulation of the free markets.

A STOLI policy is one in which a life insurance policy is taken out on behalf and for the benefit of a “stranger” to the insured. These transactions violate the sacrosanct principle that insurable interest must exist at the time a life insurance policy is issued; thus, it is appropriate that steps be taken to curtail and eliminate the issuance of STOLI. However, in attempting to address concerns over STOLI, the 2007 Model Act has arguably gone too far. It addresses STOLI by creating the so-called “5-Year Ban,” which prohibits the sale of a life insurance policy within 5 years of its issuance, unless certain conditions are met.

This is significant because it effectively extends the long-established 2-year contestability period and renders an asset owned by millions of consumers less valuable, while at the same time effectively legitimizing STOLI policies after 5 years have passed. The more logical and practical approach to the issues posed by STOLI is that put forth in the NCOIL Act. The NCOIL Act simply and clearly prohibits the issuance of STOLI, and imposes penalties on those who nevertheless engage in STOLI schemes.

The 2007 Model Act also contains a number of other provisions that seem to serve no purpose other than to overburden the industry stakeholders find themselves stretched across up to 41 separate jurisdictions, dealing with up to 41 separate regulatory agencies.”
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ans in the U.S., the service providers, trackers or life settlement estimators. Our main concern is the number of retail investment funds that are being launched from places like the Channel Islands, British Virgin Islands, Cayman Islands, the Isle of Mann, etc. None of those jurisdictions have an appropriate double taxation treaty with the U.S. When these policies mature there will absolutely be a withholding tax applied to the maturity proceeds. All of those funds who are collecting funds now from the UK are advertising and pricing their net asset values without that tax deduction. In some cases it could completely wipe out the returns that people think they’re earning.

That is our number one concern because when these funds have some maturities and when the IRS catches on to the fact that they’re not operating within a jurisdiction that has a double taxation treaty, then investors are going to think that all life settlements are part of the same brush. Some of them have a permanent residence in the U.S because of the way they’ve structured their funds. Primarily our business is asset management and financial planning products. The problem with life settlements over here is that very few people in the retail world know what risks they are taking by investing in these other funds. These risks are very real and they haven’t come to the surface yet.

How do you plan to address this concern?

We’re planning on running an education program for some of the biggest distribution groups in the UK who we know are currently recommending other funds. We have to be very careful because it might look like sour grapes on our part so we think that the best way is to get some press coverage. We have paid for tax advice. We have a number of lawyers who have reviewed these other funds and provided concerning feedback on their structure from a taxation viewpoint. The lawyers themselves don’t want to go public about their opinions. But the opinions are all in agreement that there are many risks that people are not aware of but they’re not the sort of risks that the regulator would be interested in.

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settlement industry and discourage new entrants. For instance, the 2007 Model Act extends the period of time in which a policy seller can rescind the sale of a policy to 60 days. It is a fair question to ask: What other industry in the world is required to make what amounts to an interest-free loan to the seller of an asset for up to 60 days? It is also fair to ask: What additional consumer protection interests are served by extending the rescission period from 15 to 60 days? The short answer to both questions is none.

Similarly, despite the fact that transactions are required to be closed through escrow agents and, therefore, the proceeds for payment of policy sales are not at risk, the 2007 Model Act requires brokers and providers to prove their financial responsibility by posting a bond or cash in the amount of $250,000. These bonds are expensive and difficult to obtain, and, frankly, serve no meaningful purpose. This is particularly true in light of the fact that almost all reputable industry stakeholders have errors and omissions policies with face values many times the amount of the bond required by the 2007 Model Act.

Practically speaking, the 2007 Model Act, due to its oppressive provisions, is doing more harm than good to the consumers it is ostensibly designed to protect. One need look no further for proof than the State of West Virginia. In 2008, legislators in West Virginia adopted the 2007 Model Act over the vigorous protest of the settlement industry and consumer groups. In fact, the only industry that appeared to be in favor of this legislation was the life insurance industry. Since its passage, no more than five life settlement providers have applied for licensure in West Virginia. Compare this to New Jersey - 32 licensed providers; Pennsylvania -36 licensed providers; Connecticut - 44 licensed providers; North Carolina - 44 licensed providers; and Texas - 73 licensed providers, and it is glaringly apparent how West Virginia consumers will be harmed by the lack of competition for their policies.

Regulation is appropriate if it improves productive, allocative and dynamic efficiency within an industry. By these metrics, the 2007 Model Act is not appropriate inasmuch as it decreases competition by discouraging providers from becoming licensed. To the extent that abuses continue to occur in the life settlement industry with respect to STOLI or other issues, the solution is vigorous enforcement of existing regulation, and enacting narrowly-tailored laws that address specific issues where existing legislation falls short, and not a legislative blunderbuss that discourages participation and competition within the industry.

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