# ALABAMA SECURITIES COMMISSION

## POLICY STATEMENT ON VIATICAL SETTLEMENT CONTRACTS

The Alabama Securities Commission (the "Commission") has received numerous inquiries from investors, viatical settlement companies and participants in the securities industry generally regarding the treatment of viatical settlements under the Alabama Securities Act (the "Act") *Ala. Code* §§8-6-1, *et. seq.* (1975). The Commission is aware of instances in which viatical settlements have been advertised to the investing public as 100% secure, with "guaranteed" rates of return as high as 40% or more. Many persons making such claims have not registered the viatical settlement agreements for sale in Alabama, and more often than not, the persons offering the same have not been registered under the Act as broker-dealers, agents, investment advisers or investment adviser representatives. *See, e.g.*, U.S. Investors Group Inc., No. CD-98-0075 (Nov. 19, 1998).

The Commission has the statutory responsibility to enforce the "laws governing the issuance, sale and other transactions relative to securities" in this state, and to "issue and give warnings to the public concerning securities being sold in this state. . . ." *Ala. Code* §8-6-50 (1975). Toward that end, and following a careful consideration of the applicable provisions of the Act, the regulations promulgated thereunder, prior statements of policy of the Commission and relevant case authority, the Commission has concluded that for the reasons set forth herein, viatical settlement investments should in most circumstances be treated as securities subject to the registration and other provisions of the Act.

A viatical settlement agreement generally is a written agreement entered into among a viatical company facilitating the transaction, an investor (or a group of investors) and a medically documented terminally ill person who is the owner of a life insurance policy or who is covered under a group policy insuring the life of such person. The premise behind the viatical settlement is to give those with a catastrophic or terminal illness monetary means with which to live and to pay medical expenses when the medical condition is at a stage where continued employment may not be possible. In the agreement described above, the insured agrees to sell the life insurance policy at a discount, the amount of which is based on the life expectancy of the insured, current interest rates and the profit requirement of the investors and the viatical company. The viatical company (or a trust established by the viatical company) is named as the irrevocable beneficiary and is obligated to continue making the necessary premium payments.

In the alternative, the viatical company may simply match potential buyers with the policyholders in an arrangement whereby the investor acquires direct ownership rights in the policy. Under either arrangement, the viatical company offers and sells fractional interests in the policy to investors, thus eliminating the need for direct contact between the insured and the investor. Upon the death of the insured, the viatical company receives the face value of the policy, which is then used to repay investors a profit equal to the difference between the discounted purchase price paid to the insured and the death benefit collected under the policy from the insurer, less certain administrative costs and expenses, including premiums and a commission to the viatical company.

The question of whether or not the foregoing arrangement is properly characterized as a security is answered by reference to long-standing principles governing the interpretation of the Act by both the Commission and the courts. The statutory definition of a "security," *Ala. Code* §8-6-2(10) (1975), is in all material respects identical to that contained in most state acts and the Securities Act of 1933. This definition of a security includes the term "investment contract." Alabama courts have properly followed federal precedent in adopting the definition of "investment contract" first stated in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). The *Howey* test holds that an investment contract has four principal elements or criteria: (i) the investment of money; (ii) in a common enterprise; (iii) with an expectation of profits; (iv) to be earned through the efforts of others. The Alabama Supreme Court adopted the so-called *Howey* test for determining whether or not an investment contract exists in the case of *Gallion v. Alabama Market Centers, Inc.*, 282 Ala. 679, 210 So.2d 841 (1968). In *Burke v. State*, 385 So.2d 648, 651 (Ala. 1980), the Court noted that its opinion in *Gallion*, like the United States Supreme Court's opinion in *Howey*, "intended to adopt a test which would meet the economic realities of the investment and business world." The fourth prong of the *Howey* test was, accordingly, modified to make it clear that the "efforts" referred to "are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise." 385 So.2d at 652, quoting *SEC v. Glenn W. Turner Enterprises*, 474 F.2d 476, 482 (9th Cir.) *cert. denied*, 414 U.S. 821 (1973).

We are aware of the decision in *SEC v. Life Partners, Inc.*, 87 F.3d 536 (D.C. Cir. 1996), in which the Securities and Exchange Commission ("SEC") sought to enjoin a viatical settlement company from violating the registration requirements of the Securities Act of 1933. Prior to selling fractionalized interests in life insurance policies, the viatical company evaluated the insured's medical condition, reviewed the insurance policies, negotiated a purchase price and prepared legal documents. The SEC argued that this arrangement was an investment contract under the *Howey* standard and that the company was accordingly in violation of Section 5 of the Securities Act of 1933.

Although the Court of Appeals found the first three elements of *Howey* to be satisfied, it disagreed with the SEC’s position regarding the fourth element. The court concluded that the investor’s return depended, not from the effort of the viatical company, but rather from the length of time the insured remained alive. “In this case it is the length of the insured’s life that is the overwhelming importance to the value of the viatical settlements . . . .” 87 F.3d at 548. The court noted that the fourth prong in *Howey* is concerned only with the promoter’s activities after the investor parts with his money, and that the company’s post-purchase activities in that case had no effect on the investor’s return, constituting merely administrative or ministerial functions.

The Commission does not agree with the outcome or rationale in the *Life Partner’s* decision. The Commission is of the view that the first three elements of the *Howey* and *Burke* investment contract analysis are clearly present in a viatical settlement arrangement. Furthermore, we believe there is little support, in over fifty years of judicial authority since the *Howey* decision, for drawing the “bright-line” distinction between “pre-investment” and “post-investment” managerial efforts which the Court of Appeals attempted to draw in *Life Partners*. We believe that both federal and state case law support the conclusion that the fourth element of the *Howey* definition is met when, upon a review of all of the efforts of the promoter as a whole, a court may conclude that the investor’s realization of a profit depends substantially upon the essential management efforts of the promoter, regardless of the time at which such services are performed.

In point of fact, the investors in typical viatical settlement arrangements are, as a rule, completely passive, relying upon the expertise of and information gathered by the viatical company in predicting the insured's life expectancy, preparing the documentation for investment and performing all other functions essential to the investor's ability to achieve a profit. The investors do not have the skill, knowledge or access to information to perform the tasks which are necessary for their investment to be successful.

The actions which may be, and usually are, performed by the viatical company in connection with the settlement transaction include, but are not limited to: identification of insured parties with short life expectancies; evaluation of the medical condition of the insured; analysis of the life expectancy of the insured; determination of the discount at which to purchase the policy; evaluation of the terms and conditions of the policies; effectuation of the legal transfer of the policy from the insured; effectuation of changes in beneficiaries; determination of whether an insured party has died to ensure timely submission of claims for death benefits; submission of claims for death benefits to insurance companies; acceptance of payment of death benefits from insurance companies; pooling of the policies for investors; computation and distribution of pro rata shares of benefits to investors; and other actions in the process of selecting, evaluating, acquiring and packaging insurance policy benefits to be purchased. These functions are at the very heart of the entire viatical settlement transaction; accordingly, they are the type of entrepreneurial efforts which are sufficient to satisfy the fourth prong of the *Howey* test, as interpreted by *Burke*, *supra*.

The *Life Partners* court further ignored a critical element vital to the success of a viatical investment and which must occur after the viatical agreement is consummated. This element is the necessity of payment of premiums on the viaticated policy. If this task is not performed, the policy will lapse and the entire investment will collapse. Very rarely is it left to the investor to ensure that the premiums are paid. Rather, it is the promotor's responsibility (or the escrow agent picked by the promoter) to ensure these payments are made.

In *Howey*, the Supreme Court stated that the definition of a security adopted by it in that case "embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." 328 U.S. at 299. To adopt the "bright line" distinction of the Court of Appeals in *Life Partners* would be to accept the "static principle" about which the Supreme Court warned, and to elevate the form of the transaction over its substance. The Commission is of the view that a more flexible approach is consistent with the remedial purpose of the Act, which should be interpreted broadly to afford the maximum possible protection to Alabama investors. It is also in accord with the modifications of the *Howey* test adopted by the Alabama Supreme Court in *Burke*. Moreover, the position adopted today is consistent with that of other jurisdictions. *See, e.g.*, "Division Announces its Position on Viatical Settlements," Ohio Sec. Bull. 98:3 (Ohio Div. of Sect.); *Viatical Settlement Agreements*, No. 0-01997, 1997 Wa. Sec. Lexis 21 (Wash. Sec. Div., July 14, 1997); *Viatical Settlements*, 1996 Wy. No-Act. Lexis 3 (Wy. Sec. Div. April 26, 1996); Interpretative Opinion, 1995 Kan. Sec. No-Act. Lexis 188 (Kan. Sec. Comm'r, Nov. 14, 1995).

For the foregoing reasons, we are of the opinion that investments in viatical settlement agreements as described in this statement are investment contracts, and therefore constitute securities, within the meaning of *Ala. Code* §8-6-2(10) (1975). A number of consequences flow directly from this conclusion. The Act requires that every security offered and sold in this state must be registered with the Commission unless the security itself is exempt or unless the transaction pursuant to which the security is sold is exempt. *Ala. Code* §8-6-4 (1975). If the transaction is exempt from registration under *Ala. Code* §8-6-11 (1975), the issuer should determine if the exemption is self-executing or if it requires a form filing with the Commission. If no exemption is available and registration is therefore required, the issuer should review the provisions of *Ala. Code* §§8-6-5 through 8-6-9 (1975) to determine the appropriate form of registration filing and to review other substantive and procedural requirements. Additional guidance regarding compliance with the registration provisions may be found in the Rules of the Commission.

Persons engaged in the business of effecting transactions in securities must be registered with the Commission as dealers, and individuals who represent dealers must be registered as agents, unless they qualify for an exemption from registration. Persons engaged in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issue or promulgate analyses or reports concerning securities must be registered with the Commission as investment advisers and certain individuals employed by or associated with an investment adviser must be registered as investment adviser representatives, unless they qualify for an exemption from registration.

Finally, all persons involved in the offer and sale of viatical settlements in Alabama should be aware of the nature and extent of the antifraud provisions of the Act. *Ala. Code* §8-6-17 (1975) provides that, in connection with the sale of any security in Alabama, it is unlawful to employ any device, scheme or artifice to defraud; to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they are made, not misleading; or to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person. The antifraud provisions of the Act apply in the case of every sale of a security in Alabama, including those instances in which the sale of the security is exempt from registration and the seller is exempt from licensing. Violation of the antifraud provisions of the Act is a Class C felony and can result in criminal prosecution of the offender.

Viatical settlements are investments that the Act was intended to regulate. They involve risks that investors may not realize exist and that unscrupulous promoters may misrepresent or fail to disclose to investors. The Securities Commission has concluded that viatical settlements are securities as that term is defined under the Alabama law and that it is appropriate for the Commission to assert its regulatory jurisdiction. The Securities Commission arrived at its conclusions based on current Alabama law and the long-standing public policy of investor protection. The Securities Commission has no position and makes no representations on the social value of viatical settlements.

Dated this the 27th day of May, 1999.

JOSEPH P. BORG
Director