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The Secondary Market for Life Insurance

When a person or entity buys a life insurance policy from an insurance company, either through a life insurance agent or directly from the company, the transaction is said to be in the “primary market for life insurance.” When the person or entity that bought the policy in the primary market sells (transfers the ownership rights in) the policy to another person or entity, the transaction is said to be in the “secondary market for life insurance.” After that transaction, the person on whose life the policy was originally issued remains the person whose life is insured. When the party that bought the policy in the secondary market sells the policy yet again, that resale and all subsequent resales of the policy also may be said to be in the secondary market. (Resales of a policy subsequent to the initial sale in the secondary market may be said to be in the “tertiary market for life insurance,” but I prefer to avoid that expression.)

Emergence of the Secondary Market

The secondary market for life insurance in the U.S. emerged from the shadows in 1989. Prior to that time, there were rumors about the existence of an underground secondary market for life insurance where an insured could sell the policy to a speculator in exchange for cash. The speculator would become the owner of the policy and take over the payment of subsequent premiums. The speculator would become the beneficiary of the

policy and receive the death benefit upon the insured's death. The new owner/beneficiary would be eager for the insured to die as soon as possible, so that the premium payments would stop and the death benefit would be paid. During the years I was teaching, in discussions of life insurance principles and practices, I mentioned rumors of an underground market.

Components of the Secondary Market

The secondary market for life insurance may be divided into two components: (1) "viatical settlements" involving insureds who are terminally ill, and (2) "life settlements" involving insureds who are not terminally ill. Life settlements may be subdivided into two components: (a) those involving policies originally bought for genuine life insurance purposes, such as family protection, business protection, or estate planning, and where the insureds, because of changed circumstances, decide to sell the policies in the secondary market; and (b) those involving policies originally bought for the purpose of selling them in the secondary market after the expiration of two years. (The reason for the delay is the two-year incontestability clause, which is discussed in chapter 12.) The (b) component of life settlements is what life insurance companies call "stranger-originated life insurance" (STOLI) and what I call "speculator-initiated life insurance" (spinlife). In summary, the components of the secondary market for life insurance are:

1. Viatical settlements
2. Life settlements
 - a. Genuine life settlements
 - b. STOLI or spinlife

The First Company

Early in 1989 the *National Underwriter*, a weekly insurance newspaper, ran a small story about Living Benefits, Inc. (Albuquerque, NM), a newly formed private company. The story said the company had raised \$102 million of capital and was planning to pay cash for policies on the lives of insured persons who were terminally ill. Robert T. Worley, Jr., a life insurance

agent, was president of the company. A promotional brochure included this description of the program:

LIVING BENEFITS is a company that provides a service for the terminally ill. We purchase life insurance policies with cash so one may have more living benefits at their discretion now: such as money for distribution to family members, to friends, to churches, to ministries, to schools, to hospitals, to other charities, to take a memorable trip, to retire an indebtedness, and for any other desire one might have while still living.

The brochure said: "[A]s a general rule, we are able to pay from 60% to 75% of the face value." The policy had to be "individually owned (not a group policy)," had to be in force for at least two years, and had to have a face value of at least \$50,000 and not more than \$250,000. The brochure also said: "All medical records will be held in the strictest of confidence by our medical staff."

I spoke with Worley before the company bought its first policy. He answered some but not all my questions. He said he expected most of the policies the company acquired would involve insureds who were terminally ill with cancer. I later learned it did not work out that way. When the company began operations, most of its business involved insureds who were terminally ill with AIDS.

Worley said his "medical staff" consisted of five physicians in Albuquerque, but he declined to identify them. I later spoke with the director of the University of New Mexico Cancer Center in Albuquerque. He had not heard of the program. It troubled him, and he said he was not aware of any member of his staff being involved.

Because an insured might want to know who stands to profit from his or her death, and because of the company's proximity to Las Vegas, I asked Worley about his sources of capital. He said there were one or two large investors and some small investors, but he declined to identify them. I asked about the investors because I wondered whether money from Las Vegas was involved in the speculation on human life.

When I asked about his actuary, Worley said he did not need an actuary. When I asked how the company would calculate the purchase price of a policy, he said he and his father, a retired bakery executive who had never been in the insurance business, had constructed a spreadsheet. Worley said all he needed to know was the face amount of the policy and the life expectancy of the insured. He said he did not need information about type of policy, premiums, cash values, dividends, age of the insured, or gender of the insured.

I asked Worley what he would pay for a policy with a face amount of \$100,000 on an insured person who had a life expectancy of one year. I heard a few clicks of his keyboard, and he said his company would buy the policy for \$66,025.

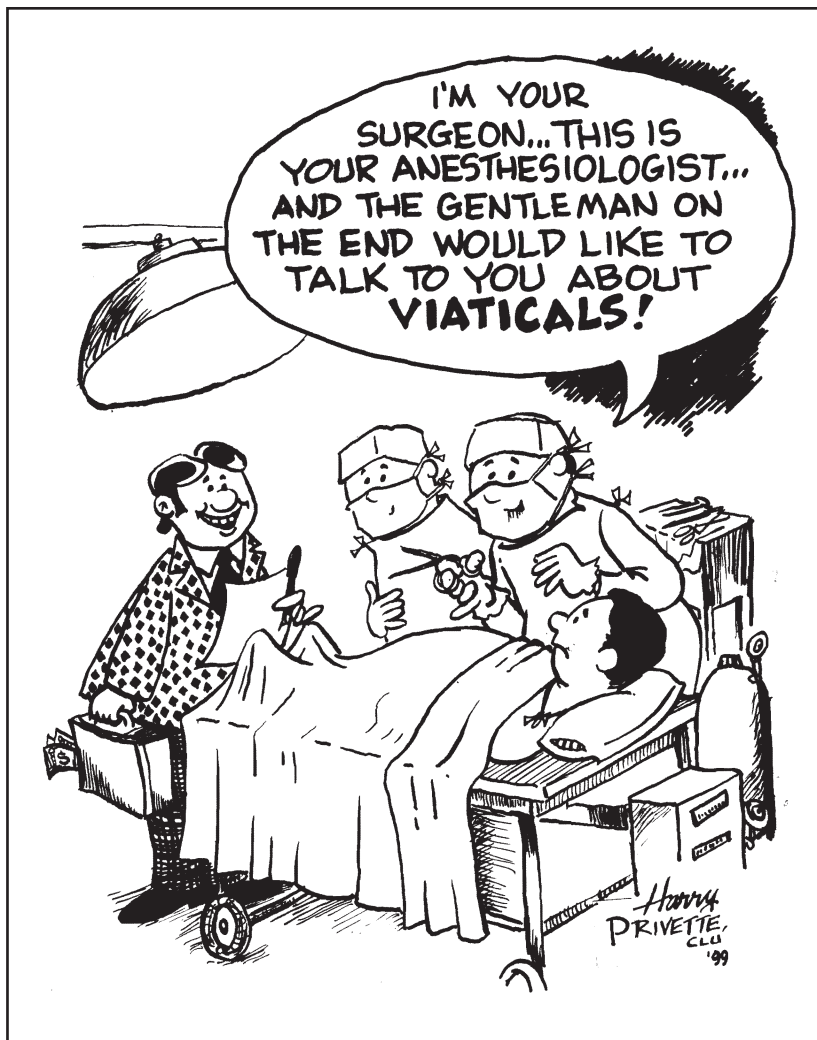
I asked Worley whether he intended to compensate individuals who referred cases to his company. He said it would be inappropriate to pay compensation, and he did not plan to do so. His answer was interesting in light of the huge compensation that later was paid to intermediaries in the secondary market for life insurance, and that became the main engine for the growth of the market.

My First Article

The four-page March 1989 issue was devoted in its entirety to my first article about the secondary market for life insurance. In the article, entitled "A System for the Exploitation of the Terminally Ill," I discussed the Living Benefits program and expressed this opinion about it:

In my opinion, the program offered by Living Benefits is a system for the exploitation of the terminally ill. I believe that any insurance company receiving a request for the transfer of a policy to Living Benefits should do what it can to discourage the transfer.

The negative views I expressed in that article about Living Benefits were based on my general distaste for speculation in human life. Today, 26 years later, I still hold negative views about the secondary market.



An Amazing Letter

Ten years elapsed before I wrote another article about the secondary market for life insurance. By that time, the market had grown to include many companies—the one with the most interesting name was Grim Reaper International—and two trade associations. By then some secondary market companies were buying policies from insureds who were not terminally ill.

I had been contemplating a follow-up article for several years, but what finally triggered it was an incident involving a 79-year-old widow in Pennsylvania. She received what

I viewed at the time as an amazing letter from Paul F. Schneider, a certified public accountant in Florida. She showed the letter to a person who by coincidence was one of my subscribers, and he shared it with me. Here is the full text of the letter (“Steve” was an attorney, and the letter included the expression “viatical settlement” because the expression was used at the time even in situations where the insured was not terminally ill):

As you may know, I am Steve’s partner. He has asked that I write to you to explain the process of obtaining an insurance policy and then selling the policy to an investor for a portion of the face value.

The concept is called a “Viatical Settlement.” A person such as yourself applies for a policy with a face value of at least \$1,000,000. Upon the issuance of the policy, an investor offers to buy the policy from you for approximately 5% of the face value or \$50,000. There is no money out of your pocket. The investor makes all premium payments. You would receive the amount directly into your bank account from the investor.

We are then paid our fee directly from you. Our fee is 20% of the funds which you receive. As an example, if you receive \$50,000 for the sale of the policy, we would be paid \$10,000 from you. The net amount of \$40,000 would be taxable to you.

I hope the above will answer any question which you may have. If you have any further questions, please do not hesitate to contact me.

Schneider’s letter was my first knowledge of what later became known as STOLI or spinlife, which are mentioned earlier in this chapter. I called Schneider. He said the market is limited to insureds aged 78 and older. In answer to my question about the names of the “investors,” he said he did not know who they were, but said he worked with four companies engaged in that type of business. I said I wanted to contact those companies, but he declined to identify them. However, he did say they were investment companies licensed to sell securities. If he had given me their names, I would have asked them what disclosures they made to the investors (speculators in human life), who actually put up the money.

In answer to my question about the names of the insurance companies that issue such policies, Schneider said there were "various" companies, and he mentioned "CNA" and "Hartford." In answer to my question about what would happen if the insured died during the two-year contestability period and the company denied payment of the death claim because of false information in the application for the policy, Schneider said it is a risk borne by the investors. I did not ask about suicide during the usual two-year suicide exclusion period, but I assume he would have said that too is a risk borne by the investors.

I later contacted some viatical companies; they denied buying newly issued policies. They said they were aware of the practice, but were unable or unwilling to identify companies in that business. They also said they were concerned about the practice, and an official in a secondary market trade association said a committee was looking into the matter.

My Second Article

The 12-page March 1999 issue was devoted in its entirety to my second article about the secondary market for life insurance. In the article, entitled "Viatical Transactions and the Growth of the Frightening Secondary Market for Life Insurance Policies," I showed Schneider's letter and described my telephone conversation with him. I also discussed numerous secondary market developments that had occurred during the decade following my first article on the subject, and examined the ways in which the secondary market violates insurance principles. Here is the concluding paragraph of the article:

Life insurance companies have the resources needed to control the excesses of the frightening secondary market for their policies; thus far only the will to use the resources is lacking. Those interested in the welfare of life insurance policy-owners and the life insurance industry, and those interested in the public interest generally, should want to see the curbing of an industry in which the basic transaction creates a large financial interest in the early death of an insured person. If viatical contracts are developed to provide adequate

protection to insureds who sell their policies and to persons who buy the policies, the sheer complexity of the transactions may discourage some of the activity in the secondary market for life insurance. Further, if rigorous disclosure requirements are adopted, so that insureds who consider selling policies and persons who consider investing in policies understand the risks and implications of the transactions, the secondary market for life insurance will be sharply curtailed. On the other hand, if the current chaotic secondary market continues to grow unchecked, homicides attributable directly to that market will occur, and the reputation of the life insurance industry will be severely damaged.

Further Articles

During the years after the March 1999 article, I wrote more than 100 articles about the secondary market for life insurance. Many of them are about STOLI or spinlife transactions, which display these characteristics:

- The insured is induced to apply for a large life insurance policy, usually with a face amount of at least \$1 million.
- The insured usually is at least 70 years old.
- The insured is lured into believing that the arrangement is without cost; the first two years' premiums usually are paid through a nonrecourse loan, where the insured pledges only the policy as collateral for the loan, but sometimes the insured is also required to provide a personal guarantee for all or part of the loan.
- The insured is bribed to apply for the policy with such inducements as an upfront cash payment, "free insurance" for the first two policy years, and a promise of a substantial cash payment when the policy is sold in the secondary market after two years.
- The plan from the outset is to sell the policy—after the two-year contestability period—in the secondary market.
- The insured is not informed about the legal, tax, and financial implications of involvement in the transaction.
- The insured is not informed that the policy can be resold many times, and that the insured probably will not know who has a strong financial interest in his or her death.

- The application for insurance often contains outright lies exaggerating the insured's net worth and income, misstating the purpose of the insurance, and understating the amount of life insurance that already exists on the insured's life.
- The intermediaries conceal from the insurance company the purpose of the arrangement, and invariably use one or more trusts to assist in the concealment.
- The insurance agent collects a large commission on the issuance of the policy.
- The premium finance company and other secondary market intermediaries receive large amounts of compensation in connection with their involvement in the transaction.

Size of the Secondary Market

Based on my experience, it is impossible to assemble reliable national data on the size of the secondary market for life insurance, for at least four reasons. First, state insurance regulators have not promulgated uniform financial statements to be filed by secondary market companies. Second, the financial statements developed by many states contain little or no information about the number or size of secondary market transactions. Third, many states require information only about transactions consummated in those states. Fourth, many states claim that the financial statements are exempt from disclosure under state public records laws.

Nonetheless some consulting firms have published data purporting to show the size of the secondary market for life insurance. They obtain the information through unsworn anecdotal comments by participants in the secondary market who themselves have limited access to reliable data.

I believe that the viatical settlements component and the genuine life settlements subcomponent of the secondary market are small, and that the STOLI (spinlife) subcomponent dominates the market. Also, the heyday of STOLI was from 2004 through 2007, and the market has since dried up, in the sense that secondary market participants who own policies are finding it increasingly difficult to resell them. In other words, investors, who are speculators in human life, are stuck with the policies and face the difficult decision of whether to keep pay-

ing premiums or allow the policies to lapse and thereby lose everything they invested in the policies.

Civil Litigation

Since the heyday of STOLI ended in 2007, there has been a huge amount of civil litigation. Some of it stemmed from efforts of life insurance companies to rescind STOLI policies on the grounds that the companies had been hoodwinked into issuing the policies by false information in insurance applications—most commonly lies about the net worth and income of the insured, the purpose of the insurance, and plans for selling the insurance in the secondary market after the expiration of the two-year contestability period.

The cases have produced varied results. In some instances, the insurance companies succeeded in persuading the courts that the insurance companies had been deceived into issuing the policies. In those cases, the companies were able to get the policies rescinded. In some instances, the insurance companies were allowed to keep the premiums that had been paid on the policies, but in other instances the insurance companies were required to refund some or all of the premiums that had been paid on the policies. In other cases the insurance companies were not able to persuade the courts that the companies were deceived into issuing the policies, and in those cases the insurance companies were not able to rescind the policies. Some articles about the civil litigation are in the December 1999, July/August 2004, January/February 2007, January 2008, February 2008, December 2009, and October 2012 issues.

Criminal Litigation

In addition to the huge amount of civil litigation, there has also been some criminal litigation. One of the first criminal cases occurred in 1999, when indictments were filed in a Texas state court against 32 individuals allegedly engaging in fraud in the viatical settlement market. Insureds suffering from AIDS were bribed to lie about their medical condition in nonmedical applications for small policies where no medical examinations were required, obtain the policies, and then sell the policies to

viatical companies. One of the ringleaders in the case was a promoter named Walter Alfred Waldhauser, Jr., also known as Michael Lee Davis. He learned about viatical settlements while he was serving prison time for murder, and he entered the viatical business after he was paroled. The case is discussed in the October 1999 and August 2000 issues.

Another criminal case involving alleged life settlement fraud led to a non-prosecution agreement between the U.S. Department of Justice and Imperial Holdings, Inc. (Boca Raton, FL). The existence of the investigation came to light when federal agents raided Imperial's headquarters in 2011. The case is discussed in the May 2012 and October 2013 issues.

There have been many other criminal cases relating to the secondary market for life insurance, usually involving STOLI activities. I wrote about some cases in the June 2000, July 2000, August 2000, April 2011, and March 2013 issues. Relevant blog posts are no. 5 (October 30, 2013), no. 19 (January 9, 2014), and no. 60 (August 8, 2014).

Life Partners

Life Partners Holdings, Inc. (LPHI) and Life Partners, Inc. (LPI), an operating subsidiary, are based in Waco, Texas. The companies were participants in the secondary market for life insurance, and LPI's main business in recent years was the sale of fractional interests in life settlements.

LPHI's top officers were Brian D. Pardo, chief executive officer, and R. Scott Peden, general counsel. Pardo beneficially owns slightly more than half the shares of LPHI. I first mentioned the organization in the March 1999 issue, and later wrote many articles and posted many blog items about it.

In January 2012 the Securities and Exchange Commission (SEC) filed a civil complaint alleging that LPHI and its top officers violated federal securities laws. I wrote about the SEC complaint in the April 2012 issue. In February 2014 the jury ruled in favor of the defendants on some charges, and against the defendants on other charges. My first blog post about the jury verdict is no. 29 (February 10, 2014).

In December 2014 the federal district court judge ordered

LPHI to disgorge ill-gotten gains and pay a civil penalty; the sum of those two penalties was more than twice LPHI's total assets. Consequently I called the order a death sentence. The judge also imposed large civil penalties on Pardo and Peden. My first blog post about the court order is no. 75 (December 10, 2014). The defendants began the process of appeal.

In January 2015 LPHI filed for bankruptcy protection under Chapter 11 of the federal bankruptcy law. In April 2015 the bankruptcy court judge approved the appointment of H. Thomas Moran, II as the Chapter 11 Trustee to operate the company in bankruptcy. The matter is very complicated and as of June 2015 appears headed for lengthy proceedings. Pardo and Peden have not paid their civil penalties; some assets have been seized and some liens have been imposed. My most recent blog post about the situation is no. 102 (May 26, 2015).

Issues and Blog Items Mentioned in This Chapter

March 1989, March 1999, October 1999, December 1999, June 2000, July 2000, August 2000, July/August 2004, January/February 2007, January 2008, February 2008, December 2009, April 2011, April 2012, May 2012, October 2012, March 2013, and October 2013, and blog nos. 5 (October 30, 2013), 19 (January 9, 2014), 29 (February 10, 2014), 60 (August 8, 2014), 75 (December 10, 2014), and 102 (May 26, 2015).