Let the Seller Beware

We all want quick and easy money. If viaticating a life insurance policy seems quick and easy, however, you probably haven't done enough homework. Get ready for Viatical 101.

February 1, 1996 By Peter Vanderwicken

Last July Richard Mitchell hired a financial planner to help him decide how to extract cash from a $190,000 life insurance policy. Mitchell, a 35-year-old New York City television producer, found a nearby planner who was recommended in a posting on America Online. "She was well-recommended," he says. The planner thoroughly reviewed his medical, disability and insurance policies, as well as his financial needs. She advised Mitchell to viaticate his life insurance policy, so he did.

Only then did he discover what the planner had missed. "She gave me information, but she didn't mention the accelerated benefits option. She also didn't bring up in any detail the federal tax liability. She didn't suggest viaticating part of the policy. She also didn't discuss a waiver of premium. She only spent about five minutes going over the issues and options."

Now Mitchell is thinking of rescinding the sale. "If I knew then what I know now, I wouldn't have done it," he says.

Mitchell's experience illustrates some of the pitfalls possible in the fast-growing practice of viatication. Typically, a life insurance policy says the policy's stated value goes to the owner's beneficiaries after his or her death. Historically it has enabled a widow to pay off a mortgage or educate the children, or gain a nest egg of capital when her husband no longer provided an income. But many PWAs are less likely to leave a widow, or a mortgage, or children. Most need cash when they are terminally ill, to support themselves and pay for their care.

Viatical settlement companies, in effect, turn a life insurance policy's holder into its beneficiary. They buy, at a discount, the policies of people with life-threatening illnesses, including AIDS and cancer, and pay them cash immediately. This cash infusion can be a godsend to PWAs without health or disability insurance or a steady income. For some, it enables them to pay the rent and buy food; it allows others to make a final dream trip to Disney World or Tokyo, or start a new business or get a graduate degree.

Viatical settlement (the name comes from the Latin *viaticum*, "provisions for a journey") is a rapidly growing, entrepreneurial, rough-and-tumble business. Since the first policy was viaticated in 1989, several dozen funding companies and a score or more of specialized brokers have sprung

up. And they are all seeking holders of valid life insurance policies to sell those policies -- often with the guidance and help of middlemen -- to the funded viatical settlement companies that actually buy the policies. (The sellers are called viators, the middlemen are called brokers and the transaction itself is called viaticating.)

Nobody knows just how big this business is or how many viators have sold their policies. A fair guess would be that last year, policies worth some $400 million were viaticated. At an assumed average of $100,000 per policy, that would mean around 4,000 viators sold their policies and received an average of around 75 percent of face value.

But the numbers could be larger. Since December 1992, for example, a single broker in San Luis Obispo, California, Benefit Advocates, has helped 441 people receive $22.6 million in benefits -- an average of $51,000 per person. With well-capitalized insurers and banks beginning to enter the business, most participants think the industry-wide volume in 1996 will grow significantly.

An unexpected but very significant problem facing potential viators is psychological. Generally, settlement companies buy policies only from people with a life expectancy of less than two years and a T-cell count below 200. The shorter the life expectancy, the more companies will pay because they get their money back sooner. “Many people think they’ll live forever,” says the man who helped create the viatical industry, David Petersen. “When somebody bets money they’ll be dead in 18 months, it’s often the first time they face reality.”

That reality makes negotiating a price with a settlement company a painful experience. “For you to increase the price,” says broker David S. Landay of National Viator Representatives, “you have to convince the funder you’re going to die before he thinks you will.” Brokers can earn their fee -- typically a five or six percent commission, paid by the settlement company -- conducting such negotiations for viators.

Partly to minimize such uncomfortable deal-making, some funding companies won’t work directly with viators but operate only through brokers. Brokers also enable clients to avoid the hassle of filing applications with several settlement companies by keeping track of each company’s current requirements. They also know which companies are currently purchasing policies, for what amounts, and which have committed all their available capital. Of course, the better deal a broker gets for a viator, the better commission it makes.

The insurance industry, meanwhile, is adopting another method to get cash into policyholders’ hands while they are still alive. An option called accelerated death benefits pays most of the policy’s value either in a lump sum or as a stream of payments over a period of months. Insurance companies that offer this option include Northwestern Mutual and New York Life. This idea started in South Africa and spread via Australia to Canada. There, in 1988, an imaginative Prudential Insurance executive, volunteering at an AIDS hospice, realized that PWAs needed cash for care more than for legacies to friends. He arranged to advance an AIDS patient $25,000 of his $35,000 policy.

The idea gradually spread to the United States, and now some 250 U.S. life insurers offer

accelerated benefits on 18 million of the 400 million U.S. life insurance policies. Most older policies still don't include the benefit, but policyholders can often have it added just by asking. In addition, many policies permit policyholders to borrow against their policy at interest rates as low as three or four percent. But an insurance policy typically must be in force for several years to build up a cash value before the policyholder can borrow against it.

Even with all these options, some people still have a need for "last resort" cash, and that need is filled by viatical settlements.

Beyond the psychological, many practical pitfalls exist for the unwary viator. The first rule is "seller beware." Most settlement companies won't consider viaticating a policy that is less than two years old, for example, because insurers can contest the validity of most policies for two years after they are issued. The policy's beneficiaries can also contest its sale (because a sale excludes them from all benefits), so most funding companies require beneficiaries' signed approval. Some group policies obtained through an employer cannot be viaticated, although many can.

Taxation is also a problem. Insurance proceeds to a beneficiary are nontaxable, but the policy's sale by its owner is a taxable sale of an asset (though brokers say most viators simply don't pay the tax). As part of its first fiscal year 1996 budget bill, Congress has made the proceeds from viaticating a policy (as well as from accelerated death benefits) nontaxable, but whether the provision will survive into a final budget law isn't yet settled. Anyone selling his or her policy may lose eligibility for such means-tested benefits as Medicaid and food stamps.

Would-be viators should also try to find a responsible broker or funding company. Some of the industry's vague and misleading advertising doesn't help. Most ads don't say whether the advertiser is a broker or a funder and don't describe its funding policies or requirements. Since a viator's financial risk is brief -- he or she gets paid in cash right away -- the real risk is annoyance after selling the policy: Will the settlement company call every month to ask if he or she is still alive? Will it peddle the policy to potential investors?

It's happened before: Brian Pardo, who runs Life Partners, a settlement company in Waco, Texas, may be one of the industry's blackest sheep. Pardo also dominates one of the two industry associations, the National Viatical Association (the sounder one is the Viatical Association of America). The Securities and Exchange Commission (SEC) has sued Pardo and his company for a raft of securities-law violations. The SEC claimed that Life Partners sold interests in policies it had viaticated as though they were unregistered securities, misled viators and investors (it claims to be the largest viatical settlement company but isn't), and didn't disclose Pardo's previous run-ins with the securities and banking laws. A federal judge in September ordered Life Partners to change its operating method. Pardo did; an SEC response was pending as *POZ* went to press.

Pardo's National Viatical Association argued strenuously that the industry doesn't need to be regulated; almost everyone else disagrees. More than a dozen states have enacted some form of regulation to protect both viators and investors (Pardo has so far successfully prevented regulation in Texas). The toughest laws are in California and New York; they strictly regulate companies'

claims and conduct and require both brokers and funding companies to be licensed. Several other states are expected to adopt similar regulations.

Like any youthful industry, viatication has its share of bad apples, bluster and confusion. As happens in any complex kind of financial transaction, some viators have been ripped off. But many viatical companies weren't started to make money. Many were created by entrepreneurs who lost a financially strapped partner or friend to AIDS and wanted to help others avoid the same situation. Several began as funding companies, financing their policy purchases with funds from investors or inheritance, then becoming brokers when they ran out of capital. Others have merged with or been bought by better-financed companies. In the last year, some large insurance and financial companies have entered the business.

Financial adviser David Petersen started the industry in 1989 as a way to get cash for one of his clients. Petersen, who also has AIDS, contacted a friend, Robert Worley, Jr., then an insurance agent in Albuquerque, New Mexico. Worley had recently heard a radio talk-show caller complain that his life insurance company had refused to buy back his policy -- even at a big discount. The caller had said he was 36 years old, had a $100,000 policy and six months to live, but neither his insurer nor his bank would buy the policy for $50,000 so he could live his last months comfortably.

Petersen and Worley saw that a new way was needed to enable cash-needy, terminally ill people to benefit from the value locked up in their own insurance policies. Worley started the first viatical settlement company, Living Benefits, and viaticated the policy of Petersen's client. Worley's company, after several mergers and sales, is now the New York City-based National Capital Management Corp.

Others soon started similar funding companies, while financial planners, trying to help friends or clients with AIDS, began viatical settlement advisory services (the brokers) to help them find the best offer among the funding companies.

David Landay, who had been a lawyer active in AIDS-related causes and president of a life insurance company, saw that many of his ill friends were unable to deal with the complex process of filing applications with settlement companies, gathering multiple copies of their medical records, confirming their policy with their insurance company, and negotiating a settlement price.

"People weren't being treated fairly," Landay says, and he saw the need for an adviser to level the playing field. Landay started National Viator Representatives to help clients through the maze.

With rapid growth and new regulation, the industry is maturing. About 90 percent of viators so far have been PWAs, but some viatical settlement companies think the concept can be expanded to help those with other terminal illnesses, including some forms of cancer, Alzheimer's disease, Lou Gehrig's disease and congestive heart failure. Lenny Bloom, chairman of National Capital Benefits, points out that the potential market beyond AIDS is much bigger than AIDS. In 1993, he says, insurance companies paid about $1 billion in benefits for deaths attributed to AIDS, but $6.5 billion in death benefits for cancer.

To expand into these potentially larger markets, settlement companies will need more capital. Most still rely heavily on a small group of investors and bank lines of credit. But a few are beginning to join the financial mainstream.

Lifetime Options, for example, is a settlement company in Alexandria, Virginia that is a subsidiary of Allstate Financial Corp. Allstate's core business is factoring accounts receivable -- buying the accounts owed to companies (including *POZ*) at a discount and providing the companies with immediate cash. In 1991, when it was approached to finance a funding company, Allstate realized that viatication follows the same principle, except with individuals instead of companies. A life insurance policy is a receivable that can be purchased at a discount -- so it started Lifetime Options. Its president, Craig Fishman, thinks Allstate's factoring expertise and $40 million in assets will enable Lifetime Options to grow through the industry shakeout he expects to come.

Another funding company, San Francisco's Dignity Partners, has led the industry into the capital market for financing. Last April Dignity raised $35 million in a private placement of securities backed by a pool of life insurance policies it had viaticated. Dignity planned to sell about $28 million in stock in January to become a publicly owned company.

One of the companies best-positioned to grow is Viaticus, based in Chicago. It is a subsidiary of CNA Financial Corp., which also owns the CNA insurance companies. Viaticus, founded by an entrepreneur named John Banks, had a typical start -- with a twist. Four years ago Banks' wife died of breast cancer, leaving him with two young children and an awareness of the high costs of a terminal illness. Devastated, he traveled for awhile, then began looking for a business where he could help people in a similar situation. After hearing about viatication, he began seeking venture capital. Banks consulted a cousin of his wife, the chairman of CNA, who was intrigued and agreed to finance Viaticus as part of CNA.

Unlike most settlement companies, which rely on brokers or advertising for clients, Viaticus markets mostly through benefits managers at Fortune 500 companies -- the same companies that buy their insurance from CNA. "With CNA's name," Banks says, "a benefits manager will agree to offer a viatical settlement option to employees' group policies because they know CNA will be here to stand behind it." Banks wants to expand the availability of viatical settlements to "anyone who's terminally ill and needs it."

Beginning to sound a little too corporate, too big-business, for the otherwise touchy-feely world of AIDS services? Lenny Bloom of National Capital Benefits couldn't agree more. "The business begun by many separate individuals who saw a need to help is quickly becoming institutionalized," he says. "Ultimately, this is an AIDS service industry. The crisis is far greater than financial planning." Until that understanding can be guaranteed in writing, however, let the seller beware. Those who do can relax with their paid-in-full bills or world-trip souvenirs receipts all the easier.

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