

'Disreputable' Viatical Investments

by Peter C. Katt, CFP, LIC

Viatical settlements involve the sale of a life insurance policy by a terminally ill insured to an intermediary (viatical firm), which then sells the policy or an irrevocable interest in the death benefits to investors. The process gets started with the viatical firm soliciting insurance agents or financial planners to find persons with terminal illnesses willing to sell their policies for a cash payment. The financial advisors receive a commission based on the face amount of the policy being sold. The viatical firm assesses the insurance policy's value and the insured's life expectancy to determine how much to charge investors for each policy. The viatical firm then markets its inventory of life insurance policies through its network of insurance agents and financial planners who earn commissions for inducing consumers to invest.

This column reports on my general knowledge and my analysis of a viatical investment made by an Iowa investor. My conclusion is that the viatical market is so inherently appalling that no respectable financial planner should ever participate in the solicitation of terminally ill persons or investors for viatical firms. *The Insurance Forum* (www.theinsuranceforum.com), published by Joseph Belth, has investigated viaticals and published many articles about them, with the first major piece in the March 1999 issue. I recommend that readers read these articles to attain a thorough understanding of the issues involved.

I was retained by an attorney on behalf of a 70-year-old Iowa widow living on a fixed income with very moderate savings whom I will refer to as Mrs. Smith. She was solicited by a local financial planner to invest in what was described as "A Sound Investment, A Humanitarian Gesture," offered by a Florida viatical settlement firm. The marketing materials given to Mrs. Smith included such statements as "A perfect no risk investment..." (attributed to a "60 Minutes" program aired 12/17/95), "Investors can reap returns of up to 25 percent per year, beating most stock funds" (attributed to *Newsweek*, March 21, 1994) and "while returns of 15 percent–20 percent are typical for investors, policies can sometimes result in more spectacular profits" (*The Wall Street Journal*, August 26, 1994).

The marketing materials, closing documents and early annual statements stated that the total fixed return on investment would be 128 percent. Also shown was the life expectancy of the insured (24 months) for the policy Mrs. Smith invested in. Mrs. Smith made her investment in April 1997. So far her investment return has failed to materialize (because the insured is still living four years later, although life expectancy was claimed to be two years) and, according to the very complicated and sometimes contradictory terms of her contract, she has been forced to begin paying premiums or lose her investment altogether.

Bundle of Deception

The sales and purchase agreement information provided to Mrs. Smith was a bundle of misrepresentations, deceptions and nondisclosures:

1. "The total fixed return on investment of 128 percent" is deceptive and false—deceptive because the total return promised is actually 28 percent. The 128 percent refers to the profit plus investment. It is also deceptive because it refers to the investment return without regard to how much time it takes to obtain it, which contradicts the promotional statements that referred to annual rates of return (ROR) on investment. For example, a total return of 28 percent produces annual RORs of 13 percent, 8.6 percent, 6.4 percent and 5 percent for two, three, four and five years respectively. And "the total fixed return on investment of 128 percent" is false because it hasn't turned out to be a fixed return at all, since Mrs. Smith has had to supplement her original investment with additional investment amounts (premiums) without the total return changing.
2. The purchase agreement falsely stated that the 28 percent total return was guaranteed.
3. How long the insured lives will dictate the value of this investment. Knowing when an insured will actually die is not possible, so the critical factor is honestly and accurately assessing an insured's life expectancy. Various documents provided to Mrs. Smith state that the insured has a life expectancy of 24 months. However, Article One of the purchase agreement states that insureds' "...life expectancy...determined by [the viatical firm]... does not exceed 48 months." So, the fine print of the agreement contradicts all of the other investor

documents that state that the insured has a 24-month life expectancy.

Since the medical records of the insured and their assessment are not disclosed to investors, they must trust that the viatical firm has properly made this appraisal. The problem is that there is no penalty to the viatical firm that routinely errs by stating shorter life expectancies than are realistic because this is a very imprecise science. Indeed, it is to the viatical firm's advantage to under-assess life expectancy because the shorter the claimed life expectancy, the higher the investment cost per promised benefit and therefore higher profits for the viatical firm.

4. For the past year, Mrs. Smith has had to pay additional amounts for premium payments to keep the policy in which she has an interest from lapsing. These amounts are in addition to a required premium reserve (paid in addition to her investment) that purported to be equal to 1.5 times the premiums needed to life expectancy. The additional payments contradict various viatical documents that stated that the total investment return, expressed as a percentage, is fixed or guaranteed. Indeed, as long as the insured is alive, Mrs. Smith must keep paying premiums. If she doesn't, the policy will lapse and her entire investment will be lost.
5. Promotional materials emphasized that the viatical investment is "fully secured" because it is "backed by an insurance company that is 'A' rated." This claim is false because it fails to mention that Mrs. Smith may have to start paying premiums if the insured lives one year beyond the stated life expectancy. If Mrs. Smith can't or won't pay premiums, the policy lapses and the "fully secured" investment is a total loss. And incidentally, even the promised "A" rated company is false. The insurance company was rated "B."
6. It was not disclosed whether the policy is term or cash-value life insurance. If it is permanent, there has been no disclosure about the amount of cash value and how it is to be used, if at all, to keep the policy from terminating. Indeed, a viatical firm can substantially profit from their manipulation of the cash values without disclosing any details to insureds or investors.
7. There was no disclosure or mention of the tax consequences of this viatical investment. A policy purchased for a business purpose falls within the reach of the transfer-for-value rules, which makes the death benefits—less the investor's cost basis—taxable as ordinary income. Even worse, because Mrs. Smith owns a fractional interest in a policy as an irrevocable beneficiary and the policy owner is the viatical firm, other adverse tax consequences could occur that I won't speculate about in this column.
8. The quote from *The Wall Street Journal* (August 26, 1994)—"while returns of 15 percent–20 percent are typical for investors, policies can sometimes result in more spectacular profits"—is verbatim, but couldn't be more deceptive. The article from which the quote is lifted is about the Securities and Exchange Commission (SEC) suing a viatical firm for "illegally trafficking in securities." The quote is from the firm's president touting his viatical business. All estimable publications are duty-bound to report the responses of even the most heinous characters who are the subject of an article. Extracting the response of a person being accused by the SEC of illegal activity is an intentional deception.

Mrs. Smith is stuck with an investment whose best result is an after-tax ROR of about 4.5 percent, but only if the insured dies immediately. If the insured lives several more years, it is questionable whether Mrs. Smith can continue premium payments to keep this policy in force. Even if she does, the ROR will be negative. If the insured lives many more years, it is certain Mrs. Smith will lose her entire investment because she will not be able to keep paying premiums. Without reflecting upon it at the time of her investment, Mrs. Smith purchased death-futures and is now in the awful position of having to wish for another human being's death in order to have any chance of getting her money back. It would be absurd to say Mrs. Smith wasn't a suitable viatical investor because this would infer that there are suitable viatical investors—there aren't. Any potential investor astute enough to be considered suitable wouldn't ever invest in such a thing.

The inherent problem with viatical settlements is that the middleman, the viatical firm, has the technical expertise to understand the very complicated assessment of the insured's medical prognosis, the life insurance policy's financial structure and how these two things affect their profitability, none of which is disclosed to soliciting agents or consumers. Being in such total control of financial information is nearly the equivalent of having a license to steal because viatical investors will always be at the viatical firm's mercy, which is why an astute investor would throw the viatical salesperson out. It is my opinion that the only way to rein in the worst behavior of viatical firms is litigation, but this probably has little chance of success because it is reasonable to assume viatical firms retain few assets since it is a cash business.

Conclusion

This leads me to conclude that the only way to make viatical settlements fair and reasonable for investors is to prohibit third-party investors altogether. That is, if the purchase of life insurance policies from the terminally ill is such a grand humanitarian gesture and such an excellent investment, let the viatical firms retain them for their own account. I suspect such regulations would essentially close down the viatical settlement industry. But that event wouldn't prevent the terminally ill from having access to accelerated benefits from their life insurance policies—many insurance companies have formal or informal procedures for extending cash benefits, using the policy as collateral. And even if an insurance company wouldn't do this, certainly a bank using appropriate medical assessment and having the policy as security would consider extending appropriate amounts.

In the case of terminally ill clients who need cash (for such things as medical treatments or income) because they are unable to continue their jobs, financial planners can help them by working with insurance companies or with local banks. Reputable financial planners shouldn't have to be told to never solicit viatical investors. Ignorant planners should become educated and take the pledge. And disreputable planners selling viatical investments should find a new way to make a living and leave the Mrs. Smiths alone.

Peter C. Katt, CFP, LIC, is a fee-only life insurance advisor and sole proprietor of Katt & Company in Kalamazoo, Michigan. His Web site is www.peterkatt.com.