

1996

## The Changing Face of Viatical Settlement Contracts

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### Recommended Citation

Jorge J. Vera Jr. *The Changing Face of Viatical Settlement Contracts*, 8 Loy. Consumer L. Rev. 331 (1996).

Available at: <http://lawcommons.luc.edu/lclr/vol8/iss4/13>

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# FEATURE ARTICLE

## The Changing Face Of Viatical Settlement Contracts

by Jorge J. Vera, Jr.

### Introduction

Viatical<sup>1</sup> settlement contracts were first created in 1988 to provide for the poorest of AIDS patients.<sup>2</sup> Viatical settlement contracts can now be entered into by anyone who is terminally ill, regardless of the type of illness. These contracts provide desperately needed hard cash during a very difficult and medically expensive time. Viatical settlement contracts possess their own specific eligibility requirements. However, viatical settlement contracts have been subjected to new insurance laws, problems of ongoing fraud, and even lawsuits.

Although a relatively undeveloped market, the current environment in the viatical settlement industry is expanding rapidly. The industry has gone from one viatical settlement provider in 1988 to over sixty today.<sup>3</sup> Over the last two years, the average cash payout has increased 10% due to increased competition between viatical settlement providers.<sup>4</sup> The viatical settlement provider's most serious problem is the assignment for cash.<sup>5</sup> Most states limit how a life insurance policy can be assigned in their general insurance laws.

### Overview of viatical settlements

Viatical settlement contracts are business transactions which involve the sale of a life insurance policy in exchange for cash.<sup>6</sup> The terminally ill person

who sells the life insurance policy is commonly referred to as a viator.<sup>7</sup> A viator is the owner of a life insurance policy which insures the life of a person with a catastrophic or life-threatening illness or condition. The viator then enters into an agreement under which the viatical settlement provider<sup>8</sup> agrees to pay cash for less than the expected death benefit of the insurance policy or certificate. The viatical settlement contract<sup>9</sup> is entered into in return for the viator's assignment, transfer, sale, devise, or bequest of the death benefit or ownership of the insurance policy or certificate to the viatical settlement provider.<sup>10</sup>

Viators may sell their life insurance policies to a viatical settlement company for a lump sum cash payment which varies from 50–80% depending on the life expectancy of the terminally ill person.<sup>11</sup> In this business transaction, viators assign their life insurance policies to viatical settlement providers; in return, the viator receives a percentage of the policy's face value. The viatical settlement company or third-party investor becomes the beneficiary to the policy, pays the premiums, and collects the face value of the policy upon the terminally ill person's death.<sup>12</sup>

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Viators sell their life insurance policies to viatical settlement providers which are private corporations and not insurance companies.<sup>13</sup> The viatical settlement company becomes the sole beneficiary of the policy by way of assignment in consideration for delivering a cash payout to the viator.<sup>14</sup>

### **The language of viatical settlements**

“Viatical settlement brokers”<sup>15</sup> offer or advertise viatical settlements for themselves or for another. Though not always industry professionals, these brokers introduce viators to viatical settlement providers or offer or attempt to negotiate viatical settlements between a viator and one or more viatical settlement providers for a fee or commission. Moreover a viatical settlement broker may not retain the services of an attorney, accountant, or financial planner (who typically represent the viator and whose compensation is paid by the viator).<sup>16</sup>

The viatical settlement contract<sup>17</sup> establishes the terms under which the viatical settlement provider pays compensation in return for the policyowner’s assignment, transfer, sale, devise, or bequest of the death benefit or ownership of the insurance policy or certificate to the viatical settlement provider.<sup>18</sup> These are the ways in which the policy can be exchanged for cash.

A viatical settlement provider<sup>19</sup> is any person who regularly engages in the trade or business of purchasing or taking assignments of life insurance contracts on the lives of insureds. A viatical settlement provider enters into a viatical settlement contract with a viator who owns a life insurance policy or a viator who owns or is covered under a group policy insuring the life of a person who has a catastrophic or life-threatening illness or condition.<sup>20</sup> Viatical

settlement providers cannot be (1) any bank, savings bank, savings and loan association, credit union, or other licensed lending institution which takes an assignment of a life insurance policy as collateral for a loan; (2) the issuer of a life insurance policy providing accelerated benefits under rules and regulations of the department of insurance; or (3) any person (not a corporation) who enters into only one viatical contract per calendar year.<sup>21</sup>

Viatical settlement companies (e.g., viatical settlement providers or brokers) cannot enter into or solicit a viatical settlement contract until obtaining a license from the state department of insurance.<sup>22</sup> Moreover, these companies must be competent and trustworthy and intend to act in good faith.<sup>23</sup> As well, they must possess a good business reputation and be recognized, under industry standards, as having experience, training, or education in the business.<sup>24</sup> The corporation must be incorporated under the laws of the state or authorized to transact business in the state.<sup>25</sup>

The industry would also like to see the process of becoming licensed simplified to increase the availability of viatical settlement agreements.<sup>26</sup> This would lead to greater availability and access of viatical settlement agreements in more states.<sup>27</sup> The feeling in the industry is that there will be a move away from the current simple percentage discount table to a more complex table in order to provide underwriting for those who live past their anticipated life expectancy.<sup>28</sup>

### **Eligibility for viatical settlement agreements**

Each viatical settlement company promulgates its own rules to determine which life

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insurance policies it will purchase and which policies are not eligible. The laws of the viator's home state (the state in which the policyowner resides) govern the sale of the life insurance policy. However, some general rules need to be followed regarding the sale of a life insurance policy.

First, a viatical settlement provider who enters into a viatical settlement contract with a person with a catastrophic or life-threatening illness or condition must first obtain (1) a written statement from a licensed attending physician that the person is of sound mind and under no constraint or undue influence; (2) a witnessed document in which the person consents to the viatical settlement contract, acknowledges the catastrophic or life-threatening illness, and represents that the person has a full and complete understanding of the viatical settlement contract and the benefits of the life insurance policy, consents to the release of medical records, and acknowledges entry into the viatical settlement contract freely and voluntarily.<sup>29</sup>

Second, in order to assure that person receives a reasonable return, all viatical settlement contracts are subject to certain minimum discounts depending on the life expectancy of the insured.<sup>30</sup>

However, the percentage might be reduced by 5% for viaticating a policy written by an insurance company rated less than the highest four categories (A++, A+, A, A-) by A.M. Best or a comparable rating by another rating agency.

The state insurance commissioner has the discretion to permit variance<sup>31</sup> from the minimum percentages by up to 10% if the commissioner determines that economic conditions have changed to warrant the variance. The department of insurance established a set procedure for ob-

taining such a variance.<sup>32</sup>

All viatical settlement contracts must contain an unconditional refund provision of at least thirty days from the date of the contract or fifteen days from the receipt of the viatical settlement proceeds, whichever date occurs first.<sup>33</sup> The viatical settlement provider must pay the proceeds of the settlement to an escrow or trust account managed by an escrow or trustee agent in a state or federally chartered financial institution that is a member of the Federal Reserve System immediately upon receipt from the viator of documents to effect the transfer of the insurance policy.<sup>34</sup> The escrow or trustee agent is required to transfer the proceeds due to the viator immediately upon receipt of acknowledgment of the transfer from the insurance company.<sup>35</sup> If the viatical settlement company fails to tender the payment by the date disclosed to the viator the contract becomes null and void.<sup>36</sup>

Additional questions need to be asked by the viatical settlement providers. The viatical settlement provider needs to know many personal facts such as whether the policy has been in force for at least two years. This question is asked to determine whether the policy falls outside the two year contestability period. Thus, proper documented response prevents the insurance company from rescinding the policy except in cases of fraud. The viatical settlement provider also wants to know the policy's face value.<sup>37</sup> This information is necessary because the face value may be for a relatively small amount. If this is the case, then it may not be cost beneficial for the viatical settlement provider to facilitate the agreement. Furthermore, the viatical settlement provider will require the viator to be in possession of a waiver from current or potential beneficiaries. The viatical settlement provider needs to gain quick access to the insurance proceeds without disput-

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ing assignment with beneficiaries.<sup>38</sup> The viatical settlement provider must know the nature of the viator's illness to determine whether a suitable risk exists.<sup>39</sup>

The viatical settlement provider may require that the policy be issued by a large or reputable insurance company. The viatical settlement provider will more than likely verify that the insurance company's A.M. Best rating is (A++, A+, A, A-),<sup>40</sup> to assess the ability of the insurance company to pay the death benefit proceeds upon the death of the terminally ill person. Life insurance policies provided through employers need to be converted to an individual policy or guaranteed to remain in force before the viatical settlement provider will accept assignment. This tactic protects the viatical settlement provider from issuing a policy which lapses because the person is no longer an employee and provides the viatical settlement provider the opportunity to continue to pay the policy's premiums to prevent the policy from lapsing. The viatical settlement provider also requires disclosure of all of the terminally ill person's medical records. The records must be released to the viatical settlement provider before such providers will place the policy with an investor or purchase the policy.

### **Government regulation**

The Health Insurance Portability and Accountability Act of 1996 ("HIPAA"), which becomes effective as of January 1, 1997, treats viatical settlement contracts as insurance related products. Furthermore, HIPAA adopted sections 8 and 9 of the National Association of Insurance Commissioners Viatical Settlements Model Act of 1994 ("Model Act").<sup>26</sup> The Model Act includes a requirement that the viatical settlement provider

disclose to the viator, no later than the date the viatical settlement contract is signed by all parties, the following information: (1) the possible alternatives to viatical settlement contracts for persons with catastrophic or life-threatening illnesses, including but not limited to accelerated benefits offered by the issuer of the life insurance policy; (2) the tax consequences of the receipt of the proceeds of a viatical settlement; (3) the adverse effects of the receipt of the proceeds of a viatical settlement, including but not limited to the claims of creditors and the recipient's eligibility for Medicaid or other government benefits or entitlements; (4) the policyowner's right to rescind a viatical settlement contract within thirty days of the date it is executed by all parties or fifteen days of the receipt of the viatical settlement proceeds by the viator, whichever is less; and (5) the date when the funds will be available to the viator and the source of the funds.<sup>42</sup>

HIPAA also codified, in section 331, the treatment of certain accelerated death benefits to be, in general, the amount paid by reason of death of an insured any amount received under a life insurance contract on the life of a terminally ill insured. Further, HIPAA codified the treatment of viatical settlements as any portion of the death benefit under a life insurance contract, which is sold or assigned to a viatical settlement provider. The amount then paid shall be treated as an amount paid under the life insurance contract by reason of the death of the insured.

Some states have adopted the Model Act.<sup>43</sup> Other states have passed similar legislation on the subject. Connecticut, Missouri, and Texas have pending legislation or have issued department of insurance bulletins.

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## Financial implications

Although no formal regulations or tax memorandum clearly explain the tax status, the sale of an insurance policy to a viatical settlement provider should not give rise to a federal income tax on the payment received by the terminally ill. The new law states that the proceeds of a viatical settlement are classified the same as a death benefit rather than as income. Therefore, such income will not be taxed. The law became effective on August 21, 1996 when President Clinton signed House Bill 3103 into law. However, states may have a their own respective tax classifications. Several states, including California and New York, nonetheless, promulgated laws making these settlements tax-free.

Entering a viatical settlement will, nevertheless, still affect eligibility for public assistance programs, such as Medicaid, based on need. Medicaid does not require policyholders to withdraw a policy's cash value or sell their policies before qualifying for benefits. However, once the policyholder cashes out or sells the policy and receives payment, the money may be counted as income for Medicaid purposes and may affect eligibility, for example, by jeopardizing one's spend down status.<sup>44</sup>

## Privacy

Any violation of the viator's home state viatical settlement act is considered by the state to be an unfair trade practice and is subject to civil and criminal penalties.<sup>45</sup> The viatical settlement provider may be found guilty of fraudulent or dishonest practices or may be otherwise shown to be untrustworthy or incompetent to act as a viatical settlement provider.<sup>46</sup>

A viatical settlement provider shall not use any viatical settlement contract in the state unless it has been filed with and approved by the state department of insurance.<sup>47</sup> The state department of insurance can disapprove a viatical settlement contract form if, in the department's opinion, the contract or provisions within the contract are unreasonable, contrary to public interests, or otherwise misleading or unfair to the policyowner.<sup>48</sup> Therefore, if the policyowner is concerned about a contract being fraudulent, the policyowner should contact the state department of insurance to verify that the proposed contract has been filed and approved.<sup>49</sup> However, at this point, nothing has been reported to be unreasonable by the various state departments of insurance. Any advertising materials and brochures used by a viatical settlement provider must also be filed and approved by the state department of insurance.<sup>50</sup>

The state department of insurance possess the authority to order any viatical settlement provider to produce any records, books, files, or other information reasonably necessary to ascertain whether the provider is acting or has acted in violation of HIPAA or otherwise contrary to the interests of the public. The viatical settlement provider must supply names and individual identification information for all viators; however, such material is considered private and confidential information which will not be disclosed by the department of insurance unless required by law.<sup>51</sup> Records of all transactions of viatical settlement contracts must be maintained by the viatical settlement provider and be made available to the commissioner for inspection.<sup>52</sup>

The viatical settlement industry, however, believes that, due to overregulation by the various state departments of insurance, the names of

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viators need to be disclosed, upon documented request, to companies with a bona fide interest and professional relationship with the viator.<sup>53</sup> Furthermore, the industry seeks a way to have referred to it persons whose policies might lapse. Accordingly, once this information is provided, the viatical settlement companies have the opportunity to distribute further information to viators.<sup>54</sup>

## Discussion

Viatical settlement contracts provide some money to help the terminally ill choose how they want to spend the last few months of their lives. The viator should know that life insurance benefits for the person who the viator originally designated as beneficiary will no longer be available to the beneficiary. Viatical settlement providers may pay 60% of the policy's face value on an insurance policy of an individual whose life expectancy is two years or less, and 80% may be paid to someone whose life expectancy is six months or less. Some companies may be willing to pay 50% of the policy's value if the life expectancy is more than twenty-four months.

When considering a viatical settlement contract, the terminally ill person should investigate private, non-profit organizations, and state agencies. For example, contacting two or three viatical settlement companies to ensure the offers are indeed competitive is suggested. Terminally ill persons must also be aware of the industry discount rates. Furthermore, those contemplating viatical settlement contracts may wish to contact the Viatical Association of America (800-842-9811), a non-profit organization. This association can provide a list of companies, which are members of their association. How-

ever, this association is funded by its members and, therefore, has a vested interest in keeping its industry successful.

In addition, the state departments of insurance serve as an excellent resource. These public agencies can provide names of viatical settlement companies and their locations and phone numbers and whether the viatical settlement company is licensed in that state. Moreover, the state departments can provide information regarding viatical settlement companies or broker licensing and also, whether that particular state has adopted regulations regarding the viatical settlement contract. The status of the viatical settlement company should be verified to assure the company is licensed and is in compliance with state laws and regulations.

Once an individual begins to carefully examine the viatical settlement document, there are a few factors to consider. The viatical settlement contract should include a "cooling off" or "free-look" period before the viatical settlement transaction is complete. These contracts typically provide a 30 day separation period away from the broker—who may be pressuring the viator into signing the agreement. The provider's ability to pay the viator immediately is critical. The terminally ill individual should also realize the viatical settlement company may sell the policy to a third-party investor. That is, large companies may have a cash surplus, where smaller companies may have uneven cash flows or may need to market the policy to third parties with the hope that a third party will purchase the policy. Therefore, companies should set up an escrow account with a reputable financial institution at the beginning of the transfer to ensure that funds are available for the policyholder. For intrastate deals, the funds may even be wire transferred to the viator's

bank account.

Because time is of the essence, no more than a few months should lapse from the policyholder's initial contact with the company to the closing date. Typically, the reason for the delay is the waiting period prior to receiving confirmation of the assignment being recorded by the insurance company. Another issue to be aware of entails the concern some viatical settlement providers may not protect a policyholder's privacy when the company acts as the broker for payouts from the potential investors.

Persons pursuing viatical settlement agreements should facilitate as much of the process themselves. For instance, medical records may be obtained at the expense of the viator. Also, viators may wish to obtain releases from their beneficiaries. Finally, viators will want to discuss their situations with their doctors in anticipation of the need for a determination of terminal illness.

## Conclusion

The viatical settlement contract has gone from being a ghoulish taboo to a blessing to those who are in need of cash for those last few months of their lives. However, as in any industry, unscrupulous people lie in waiting to take advantage of the terminally ill. The regulation and expansion of this industry will continue to evolve. Everyone who is tied to this industry, whether it be the viatical settlement company or the viatical settlement broker or the state department of insurance must always place the public interest as a top priority. The parties involved must continue to protect the ill and conduct business professionally and with compassion, never forgetting these are people's lives and not merely numbers with face amounts, cash values, and death benefits.

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## E N D N O T E S

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<sup>1</sup> Viatical is defined as "provisions for a journey (in the form of food, money, etc.)." OXFORD LATIN DICTIONARY 2054 (P.G.W. Glare ed. 1976).

<sup>2</sup> Jennifer Berner, Note: *Beating the Grim Reaper, or Just Con-fusing Him? Examining the Harmful Effects of Viatical Settlement Regulation*, 27 J. MARSHALL L. REV. 581, 584 (1994).

<sup>3</sup> Malcolm Osborn, *Rapidly Developing Law on Viatical Settlements*, 31 WAKE FOREST L. REV. 471, 472 (1996).

<sup>4</sup> Viatical Settlements Working Group of the Life Insurance (A) Committee, New York, N.Y. National Association of Insurance Commissioners ("NAIC") Conference Minutes, p. 3 (June 1996).

<sup>5</sup> *Id.* at 2.

<sup>6</sup> Viatical settlement contracts differ from accelerated benefits which are sometimes called living benefits. Accelerated benefits are proceeds of life insurance policies which insurance companies pay to the person just before death. These benefits are included in policies when sold. In addition, they are

usually offered as riders to new policies. Life insurance policies may include an accelerated benefits provision. Life insurance companies offer anywhere from 25–100% of the death benefit as early payment, but policyholders can only collect these payments under very specific circumstances and generally only when given six months to live. The amount and method of payment may vary with the policy depending on the length of time the policy has been in force.

<sup>7</sup> Viatical Settlements Model Act, NAIC § 697-1 (1994).

<sup>8</sup> *Id.*

<sup>9</sup> *Id.*

<sup>10</sup> *Id.*

<sup>11</sup> *Id.* § 698-1.

<sup>12</sup> Federal Trade Commission, *Viatical Settlements: A Guide For People With Terminal Illnesses* (1995).

<sup>13</sup> *Id.*



<sup>14</sup> *Id.*

<sup>15</sup> *See supra* note 7 § 697-1.

<sup>16</sup> It should be noted that California law does not allow anyone licensed as an insurance agent to be a viatical settlement broker. On the other hand, Louisiana law requires viatical settlement brokers to be licensed as insurance agents as well.

<sup>17</sup> *See supra* note 7 § 697-1.

<sup>18</sup> *See infra* p. 332.

<sup>19</sup> *See supra* note 7 § 697-1.

<sup>20</sup> *Id.*

<sup>21</sup> *Id.*

<sup>22</sup> *Id.* § 697-2.

<sup>23</sup> *Id.* § 697-3.

<sup>24</sup> *Id.*

<sup>25</sup> *Id.*

<sup>26</sup> *See supra* note 4.

<sup>27</sup> *Id.* at 2.

<sup>28</sup> *Id.*

<sup>29</sup> *See supra* note 7 § 697-5.

<sup>30</sup> The discounts include: (1) whether the insured's life expectancy as jointly determined by the insured's physician and the viatical provider is less than six months, then the minimum percentage of the face value, less any outstanding loans received by the viator, must be eighty percent; (2) whether the insured's life expectancy as jointly determined by the insured's physician and the viatical provider is at least six but less than twelve months, then the minimum percentage of the face value, less any outstanding loans received by the viator, must be seventy percent; (3) whether the insured's life expectancy as jointly determined by the insured's physician and the viatical provider is at least twelve but less than eighteen months, then the minimum percentage of the face value, less any outstanding loans received by the viator, must be sixty-five percent; (4) whether the insured's life expectancy as jointly determined by the insured's physician and the viatical provider is at least eighteen but less than twenty-four months, then the minimum percentage of the face value, less any outstanding loans received by the viator, must be sixty percent; (5) whether the insured's life expectancy as jointly determined by the insured's physician and the viatical provider is twenty-four months or more, then the minimum percentage of the face value, less any outstanding loans received by the viator, must be fifty percent. *See supra* note 7 § 697-2.

<sup>31</sup> The insurance commissioner has the authority to change the minimum percentage if the economic climate changes. This authority places the viator at a disadvantage unless the minimum discount is decreased to give the viator a higher percentage. *Id.*

<sup>32</sup> *See supra* note 7 § 697-5.

<sup>33</sup> *Id.*

<sup>34</sup> *Id.*

<sup>35</sup> *Id.*

<sup>36</sup> *Id.*

<sup>37</sup> *Id.* § 698-3.

<sup>38</sup> *See supra* note 4 at 2.

<sup>39</sup> Generally, a suitable risk means a life expectancy of less than two years. A policy definition of the life expectancy timeline is of great importance in light of the recent collapse of Dignity Partners Inc., which primarily purchased the policies of AIDS patients, many of whom are still alive. Kenneth Howe, S.F. CHRON., Oct. 10, 1996, Business at 1.

<sup>40</sup> *See supra* note 7 § 698-3. The [return] percentage [a] policy may be reduced [is] by 5% for viaticating a policy written by an insurer rated less than the highest 4 categories by A.M. Best, or a comparable rating by another agency.

<sup>41</sup> Pub. L. No. 104-191 (1994).

<sup>42</sup> *See supra* note 7 § 697-4.

<sup>43</sup> California, Florida, Illinois, Indiana, Kansas, Louisiana, Minnesota, New York, North Carolina, North Dakota, Oregon, Utah, Vermont, Washington, and Wisconsin have adopted the Model Act with either few or no changes. Viatical Settlement Model Act, Model Regulation Service, July–October 1994; Viatical Settlements Working Group of the Life Insurance (A) Committee, New York, N.Y. National Association of Insurance Commissioners ("NAIC") Conference Minutes, (July 1996).

<sup>44</sup> Spend down is a Medicaid concept where a Medicare recipient must use all available resources down to \$2,000 before Medicaid pays any prescription charge.

Robert J. Buchanan and Scott R. Smith, *Medicaid policies for HIV-related prescription drugs; Prescription Drugs: Payment and Policy Issues*, HEALTH CARE FINANCING REVIEW, Vol. 15, No. 3, at 43 (March 22, 1994).

<sup>45</sup> *See supra* note 7 § 697-2

<sup>46</sup> *Id.* § 697-3.

<sup>47</sup> *Id.*

<sup>48</sup> *Id.*

<sup>49</sup> *Id.*

<sup>50</sup> *Id.* § 698-4.

<sup>51</sup> All medical information solicited or obtained by any viatical settlement provider is subject to the state law governing the confidentiality of medical information. *Id.* § 697-3.

<sup>52</sup> *Id.* § 698-3.

<sup>53</sup> *See supra* note 4 at 2.

<sup>54</sup> *Id.* at 3.