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The *WRNewswire* is created exclusively for AALU Members by insurance experts led by Steve Leimberg, Lawrence Brody and Linas Sudzius. *WRNewswire #15.06.01* was written by *Steve Leimberg,* co-author with Howard Zaritsky of Tax Planning With Life Insurance, Publisher of Leimberg Information Services, Inc. (LISI) and Creator of NumberCruncher Software.

TOPIC: Supreme Court of Texas: Life Settlement is Security

CITATION: *Life Partners, Inc. v. Arnold and Life Partners Holdings, Inc., v. State of Texas*, Nos. 14–0122,and 14–0226, 2015 WL 2148767 (S.Ct.TX May 8, 2015); *In re LPHI,* No. 15-40289-RFN-11 (U.S. Bankruptcy Court, N. Dist. Tex. 2015).

SUMMARY: The Supreme Court of Texas held in two separate cases that a "life settlement agreement" or "viatical settlement agreement" is an "investment contract" and thus a "security" under the Texas Securities Act. The court reasoned that the agreements sold by Life Partners were investment contracts because they constituted transactions through which: (1) a person paid money; (2) to participate in a common enterprise; (3) with the expectation of receiving profits; (4) under circumstances in which the failure or success of the enterprise and the person's realization of the expected profits was at least predominately due to the entrepreneurial or managerial efforts of others.

The court refused to give its holding only prospective application. It applied the holding retroactively to emphasize that it was not making new law but rather restating the law as it *should* have been applied at the inception of these life settlement transactions.

RELEVANCE: The point of this case is: The term "security" can be broadly construed to afford the investing public "a full measure of protection."

At this year's AALU Annual Meeting, **Larry Brody** and **Linas Sudzius** and I repeated our warning based on the November, 2013 LLOYD'S case (*Certain Interested Underwriters at Lloyd's v. AXA Equitable Life Insurance Company, et al.,* United States District Court, S.D. Florida, No. 10-622061-CV-Hurley/Hopkins) that an errors and omission policy will not cover the activity of a producer who sells a product outside the scope of the contract's specific coverage (i.e. if the policy covers life insurance but does not cover investment products).

This case makes it clear that—at least in *some* instances and *some* states—life settlement transactions, particularly at the "back-end", can be considered an "investment" rather than a "life insurance" contract. Therefore, it is important to be careful. If you are involved in life settlements, you may (or may not) be at risk. Note that the decision in this case focuses on the sale of interests in a life insurance contract to investors. It does not address the sale or brokerage of policies to life settlement companies. Clearly, this case affirms that the securities laws can apply to life settlements from the point of view of the buyer of policies who sells interests in those contracts to investors. It may have no relevance from the point of view of the insured who sells his or her policy to a third party, nor from the point of view of the agent who sells the policy to the insured or brokers it to life settlement companies. Can a life settlement be insurance for some purposes and an investment for others? That question is yet to be determined.

Regardless of the future scope of the holding of this case, it would be wise to check your coverage. (Also, read carefully the elements this court considered as constituting an investment. You may be surprised to know that certain *other* life insurance related "packages" or transactions may fall into the "investment" rather than "life insurance" category.) In addition, it would be wise, to be careful of what you are selling. If it meets the tests below, it may be considered a security by either or both state and federal laws.

FACTS: According to the court, in *Life Partners, Inc. v. Arnold*, Michael and Janet Arnold and others filed a class action lawsuit seeking rescission and damages based on claims that Life Partners, Inc. and others violated the Texas Securities Act by selling unregistered securities and materially misrepresenting to purchasers that they were not, in fact, securities. In the second case *Life Partners, Inc. v. State of Texas*, the State of Texas sought an injunction and other relief based on allegations that Life Partners and others had committed fraud in connection with the sale of securities.

According to the court, since 1991, Life Partners has been engaged in the business of life settlements, i.e. buying existing life insurance policies from policy owners and then selling interests in those policies to others. Life Partners purchased the policy from the insured for a "cash settlement" of less than the amount the policy would pay at the time of the insured's death. To fund these purchases and its own business operations, Life Partners sold interests in the policies' future benefits to "investors" or "purchasers." The process thus involved at least two distinct business transactions:

1. Life Partners would buy the policy from its owner.
2. Life Partners would sell interests in the policy to purchasers.

What the court ruled was that this second transaction constituted the sale of a "security" under the Texas Securities Act.

According to the court, Life Partners itself advertised life settlement agreements as a "sure thing" investment. Its sales pamphlet asserted:

> There's no need to worry about which way the wind is blowing. The returns on life settlements, unlike stocks, mutual funds and other investments, are unaffected by market fluctuations, business cycles, the economy or global unrest.

Life Partners assured purchasers that, *"[n]ot only are your investments safe from these market risks, they have the opportunity to provide exceptional return on investment."*

According to the court, the reality was that Life Partners calculated a policy's value based on the insured's life expectancy and had to pay the policy's premiums until the insured's death to collect on the policy. However, due to miscalculations, the anticipated returns often were diminished and sometimes lost because the insured lived significantly longer than Life Partners had projected. Mechanically, when selecting policies to purchase on behalf of the purchasers of interests in the policy, Life Partners:

- identified insureds interested in selling their policies,
- evaluated their medical condition,
- predicted their life expectancy,
- evaluated the policies' terms and conditions to ensure they were assignable, and
- determined how much to pay for the policies.

According to the court, buyers depended upon Life Partners' ability to predict life expectancies and set the appropriate prices. If the insured survived longer than projected, when the escrowed amount was depleted, Life Partners required purchasers to provide additional funds. If they didn't, they lost everything. At times, when Life Partners' prediction turned out to be inaccurate or its negotiations ineffective, the purchasers had to pay more to cover premiums than they would receive when the insured died.

Life Partners took the money it received on the sale of interests to:

1. pay the insured for the policy,
2. create an escrow account to pay the policy's future premiums,
3. pay fees to escrow agents and brokers who helped sell interests to purchasers and
4. pay Life Partners an administration or brokerage fee.

According to court records, Life Partners never disclosed to the purchasers how much of their investment went to each of these purposes. Instead, it gave them only a total "acquisition price." Until they paid that price, they received no information about the insureds or their policies. Once they did, the purchasers received a "Confidential Case History" that contained information about the insured's illness and life expectancy, the policy's grade, value, and annual premium payment, and the amount Life Partners had escrowed to make those premium payments. Although Life Partners occasionally provided purchasers with updates on an insured's medical condition or life expectancy, according to the court, "it often lost contact with the insured."

According to the court, Life Partners was responsible for monitoring insureds. At an insured's death, Life Partners was required to:

- obtain the death certificate,
- submit a claim to the insurer and
- facilitate payment of proceeds according to a purchaser's fractional interest.

In other words, purchasers *relied* on Life Partners both *before and after* they purchased their interests. A purchaser who wanted to divest had no secondary market for the purchaser's interest and so had to rely on Life Partners to coordinate a sale to another interested purchaser.

The term "security" is broadly defined under Texas (and most other state's) law. The term includes "any limited partner interest in a limited partnership, share, stock, treasury stock, ... investment contract, or any other instrument commonly known as a security." Texas based its definition of security on the definition of that word in the Federal Securities Act of 1933 and looked to federal cases and other authorities for guidance in construing the term.

Three key principles were used by this court and seem likely to be used again by future courts—not only in Texas but in other states (and perhaps under federal law)—to shape the construction and application of the term "investment contract":

1. The term is construed broadly to maximize investors' protection.

2. Focus will be on the economic reality of the transaction in question.

3. If economic reality shows a transaction is an investment contract, state investment laws will be applied *regardless* of any labels used by the parties.

In other words, substance and economic reality will trump form.

Texas law (similar to many other states) defines an "investment contract" as

(1) a contract, transaction, or scheme through which a person pays money
(2) to participate in a common venture or enterprise
(3) with the expectation of receiving profits,
(4) under circumstances in which the failure or success of the enterprise, and thus the person's realization of the expected profits, is predominately due to the entrepreneurial or managerial, rather than merely ministerial or clerical, efforts of *others*, regardless of whether those efforts are made before or after the transaction.

The touchstone is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of *others* - i.e. efforts made by those other than the investor are the significant essential managerial engines which affect the failure or success of the enterprise.

The court then applied the test of whether there was:

(1) Investment of money?
(2) A common enterprise?
(3) Expectation of profits?
(4) Expected profit based on reliance upon the managerial efforts of others?

According to the court, to qualify as an investment contract, an *investor's* duties, if any, must be nominal and insignificant. The investor's role must be perfunctory or ministerial and must lack any real control over the operation of the enterprise. Thus, in reality, the purchaser's anticipation of profits in an investment contract must be based upon a third party who exercises predominate managerial or entrepreneurial control.

Here, the court found that Life Partners' *purchasers* were "essentially passive." They relied for their anticipated profits almost totally on Life Partners' "pre-purchase expertise in identifying existing policyholders and ... post-purchase management of the investment." Note that the entrepreneurial or managerial efforts that are relevant to this inquiry, whether those of the purchasers or of others, include those that are made *prior* to the transaction as well as those that are made *after*. The relevance to the Act's purpose to protect investors is not the timing of the efforts but the efforts' role in the transaction as the factor on which an investor predominately relies.

The Texas Supreme Court applied this definition to the undisputed material facts and concluded that Life Partners' life settlement agreements were "investment contracts" and thus "securities" under the Texas Securities Act.

The test the court described for determining whether a transaction is an investment contract "is what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect."

Applying all the above principles to this case, the court reasoned that Life Partners was the facilitator and administrator of the investments in life settlements through its power of attorney. It identified the insured, negotiated the discount for the policy, evaluated the policy's terms and conditions, and evaluated the health of the insured. It purchased the policy and found purchasers to buy an interest in the policy until all interests were sold.

According to the court, the pre-purchase efforts required Life Partners to accurately evaluate the insured's life expectancy and to set the correct purchase price (the discount) to yield a profit based on the insured's life expectancy, future premiums, and end-value of the policy's benefits. If Life Partners' prediction was accurate, the purchaser would receive a profit. Purchasers of interests "depended upon its ability to predict life expectancies and set the appropriate prices," and its pre-purchase entrepreneurial efforts are "undeniably essential to the overall success of the investment."

After the purchase, Life Partners exercised complete control and discretion over the investment and the investment's success. It held legal title to the policy, monitored the insured and policy premium payments, and collected and distributed the necessary funds. It used its discretion to project the amount necessary to place in escrow to cover the premiums, and was responsible for notifying purchasers if additional premiums were required because an insured survived beyond Life Partners' predicted life expectancy. Life Partners' failure to properly project and maintain premiums would result in forfeiture of the policy, and therefore, the investor's profits. The purchasers had neither the power to complete these tasks nor the information necessary to do so, but would lose some or all of their anticipated profits if Life Partners failed to perform as it promised.

Life Partners requested that the court provide its holding would have only prospective effect, and thus alleviate Life Partners from any liability to the Arnolds or the State in these cases based on its prior conduct. However, the court held that its decision in this case did not "establish a new principle of law" by "overruling clear past precedent on which litigants may have relied, or by deciding an issue of first impression whose resolution was not clearly foreshadowed." It stated that it was merely interpreting and applying a very old law, consistent with the manner in which other courts have interpreted and applied it for decades. Finally, it stressed that retroactive application of its holding furthered the operation and enforcement of the Securities Act, and imposed no inequities on Life Partners.

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