BOBBIE J. GRIFFITTS, On Her Behalf and All Others Similarly Situated,	§	
	§	IN THE TENTH COURT OF APPEALS
Appellants	§	
	§	
v.	§	McLENNAN COUNTY
	§	
LIFE PARTNERS, INC.	§	
	§	WACO, TEXAS
Appellee	§	

NO. 10-01-00276-CV

***Brief of the Amicus Curiae*: North American Securities Administrators Association, Inc., On Its Own Behalf**

Royce O. Griffin, General Counsel
Member, Arkansas Bar
Mark J. Davis, Associate General Counsel
Member, District of Columbia Bar
Stephen W. Hall, Associate General Counsel
Member, District of Columbia Bar
Attorneys for
North American Securities Administrators Association, Inc.
10 G Street, N.E., Suite 710
Washington, D.C. 20002
(202) 737-0900 Voice
(202) 783-3571 Fax

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No Fee Has Been Paid or Will Be Paid to NASAA for Preparation of This Brief

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STATEMENT OF THE CASE

On September 28, 2000, Plaintiff-Appellant Bobbie J. Griffitts ("Griffitts"), on her behalf and all others similarly situated, brought an action in the 19th Judicial District Court of McLennan County, Texas, against Defendant-Appellee Life Partners, Inc. ("Life Partners"). Griffitt's putative class action asserted that Life Partners had offered and sold unregistered securities in the form of viatical settlement contracts, in violation of the Texas Securities Act, TEX. REV. CIV. STAT. ANN. art. 581-1 *et seq.* (Vernon 1964 and Supp. 2002) ("Act" or "Texas Act"), and further had marketed those securities through sales agents that were not registered in accordance with the Act. Griffitts sought

rescission, pre- and post-judgment interest, attorneys' fees, exemplary damages, and costs. (I C.R. at 4)

After limited discovery and the filing of cross-motions by the parties, The Honorable Ralph T. Strother, Judge of the District Court, granted Life Partners' Motion for Summary Judgment. The court held (1) that the viatical settlement contracts sold to Griffitts were not securities under the Texas Act, because they were not "investment contracts," "notes," or "evidence of indebtedness" within the meaning of the Act; and (2) that the contracts were expressly excluded from the definition of securities under the Act as contracts or agreements "in relation to and in consequence of" life insurance policies. (IV C.R. at 739). Griffitts filed this appeal.

<u>ISSUES PRESENTED</u>

Whether the viatical settlement contracts[1] sold to Griffitts are securities under the Texas Securities Act, where they satisfy all elements of the investment contract test under *Howey*, as that test has been applied by the vast majority of courts prior to and since the decision of the D.C. Circuit in *SEC v. Life Partners.*

Whether the viatical settlement contracts sold to Griffitts are securities under the Texas Securities Act, where they were structured as notes that are presumed to be securities under Texas law, and where they lack any of the attributes necessary to rebut that presumption.

[1] The label "viatical settlement contract" is the term most commonly used by courts and legal scholars to denote the investments packaged and sold to investors by "viatical settlement companies," and it is therefore used extensively in this brief. Other terms also are applied, such as "viatical product" and "viatical investment." The intent is the same. The term "viatical settlement contract" has a specialized and different meaning in the context of the Texas Insurance Code, as discussed *infra.*

Whether the insurance exclusion under the Texas Securities Act should be interpreted to cover the viatical settlement contracts sold to Griffitts, even though the contracts do not meet the plainly worded requirements of the exclusion, and even though applying the exclusion would leave viatical settlement contracts entirely unregulated from the standpoint of public investors.

STATEMENT OF INTEREST OF THE *AMICUS CURIAE*

The North American Securities Administrators Association, Inc. ("NASAA") is the oldest international organization devoted to the protection of investors in securities. It is a voluntary association organized in 1919 that now has a membership comprised of 66 state, provincial, and territorial securities regulators, including members in all 50 states and the District of Columbia. State securities regulators are responsible for ensuring that securities are offered and sold only in accordance with state securities laws and regulations, which have been adopted in some form in every state to protect investors from fraud and abuse. As the organization that represents the interests of investors as well as securities regulators, NASAA seeks to enhance investor protection and increase uniformity in the interpretation of state securities laws. Both of these goals are at stake in this case.

I. Protecting Investors

NASAA has an interest in protecting investors in Texas by helping to ensure that those who purchase viatical settlement contracts continue to receive the regulatory safeguards provided under the Texas Securities Act. Historically in Texas (and

throughout the vast majority of states), viatical settlement contracts have been regarded as securities and therefore regulated as such. As a result, Texas citizens have been entitled to the protections conferred by the Texas Securities Act, including testing and licensing of sales agents; registration of investments; mandatory pre-purchase disclosure of material information; and strong remedial and punitive sanctions against violators. To the extent the lower court's ruling stands and viatical settlement contracts are no longer treated as securities, public investors in Texas will be deprived of these important safeguards.

NASAA's interest in seeing that viatical investments are properly regulated stems from a simple fact: over the last decade, there have been widespread abuses in the sale of viatical products, and as a consequence, thousands of investors have lost money. While some viatical companies have not been embroiled in scandal, the industry in general has been characterized as "infected with scam artists, 'ponzi' schemes, and other fraudulent activities." Lisa M. Ray, Comment, *The Viatical Settlement Industry: Betting on People's Lives Is Certainly No Exacta*, 17 J. CONTEMP. HEALTH L. & POL'Y 321, 322 (2000). The potential for easy money has created a strong incentive for firms to defraud investors, as they seek market share in an industry estimated to have grown from $1 billion in sales in 1999 to as much as $4 billion in 2000. Joy D. Kosiewicz, *Death for Sale: A Call to Regulate the Viatical Settlement Industry*, 48 CASE W. RES. L. REV. 701, 702 (Spring 1998); Ffiona M. Jones, *The Viatical Settlement Industry: The Regulatory Scheme and Its Implications for the Future of the Industry*, 6 CONN. INS. L. J. 477, 483, 498 (1999-2000).

The patterns of investor abuse in the marketing of viaticals are well documented. Many investors have sustained losses due to outright fraud, as when viatical settlement companies deliberately sell non-existent policies or simply pocket investment proceeds. For example, in the late 1990's, a viatical settlement company known as American Benefits Services, Inc., offered investors in Texas and other states a 42 percent rate of return, with 15 percent guaranteed. Over three thousand people invested $117 million. The funds were forwarded to another viatical settlement company, Financial Federated Title & Trust, which spent only $6 million to buy interests in actual life insurance policies. The rest was diverted for the personal benefit of the company organizers. *See* Lawrence A. Frolik, *Insurance Fraud on the Elderly*, 37 TRIAL 48, 51-52 (June 2001), *citing In re Fin. Federated Title & Trust, Inc.*, 252 B.R. 834 (Bankr., S.D. Fla. 2000).

Other opportunities for fraud abound in the marketing of viatical investments. Viatical companies may misrepresent the medical condition of the viators, particularly if the certifying physicians are not truly independent. In many instances, policies have been sold with assurances that the insured is very ill and likely to die soon. When viators live on, investors find that premiums must be paid for indefinite periods to avoid lapse of policies and forfeiture of investments. *See* Frolik, *supra*, 37 Trial at 51. Viatical companies also may intentionally fail to set aside adequate reserves to make premium payments. And of course, sales agents can make bold and unsupportable claims about the rates of return or the performance of viatical investments relative to the stock market.

Fraudulent practices are not limited to viatical companies: in many cases, viators have committed fraud against insurers by lying about their own medical conditions. *See*

Miriam R. Albert, *The Future of Death Futures: Why Viatical Settlements Must Be Classified as Securities,* 19 PACE L. REV. 345, 368 (1999) (identifying at least four types of fraud associated with viaticals). Unfortunately, investors are harmed either directly or indirectly by all of these types of fraud, because even fraud by a viator can have the downstream effect of voiding a policy and eliminating any chance that an investor will recover any portion of his or her initial investment.[2]

Fraud may also be committed through the failure to disclose material information. There are many risks associated with viatical investments and information about these risks may not be adequately disclosed to prospective investors by viatical settlement companies or their sales agents. For example, rates of return are difficult to predict – and yields vary greatly – because of uncertainties in calculating viator life expectancy. The health of viators must be monitored so death certificates can be obtained at the proper time. Viatical products are not liquid investments. There is no return until viators die and claims for death benefits are paid. There is little recourse for an investor needing access to his or her funds since a secondary market for viatical investments contracts is virtually non-existent. *See* Michael Cavendish, *Policing Terminal Illness: How Florida Regulates Viatical Settlement Contracts*, 74 FLA. B.J. 10, 14 (Feb. 2000).

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[2] A viator might obtain a policy by lying to the insurance company about his or her condition, or lying to the viatical company about the gravity of the underlying illness or the transferability of the policy. When the insured dies, the investor may not be able to collect because of the viator's fraud. *See State v. Viatical Services, Inc.*, 741 So.2d 560, 561 (Fla. Dist. Ct. App. 1999), *review denied*, 753 So.2d 567 (Fla. 2000). Even if the viatical company does not know that the insured lied, the policy may still be challenged and investments lost. *See Protective Life Insurance Co. v. Sullivan*, 682 N.E.2d 624 (Mass. 1997). The practice of a viator using false pretenses to obtain a policy in collusion with the viatical company is commonly termed "cleansheeting." Michael Davis and his viatical company, First American Fidelity Corporation, were indicted by a Dallas Grand Jury for selling interests in $10 million of life insurance policies to investors that had been obtained by "cleansheeting." HIV-positive men obtained the policies by lying about their physical conditions. Jones, *supra*, 6 CONN. INS. L.J. at 500-501. In *Amex Life*

There are other risk factors and fees associated with viaticals that may not be disclosed to investors. Policies that have been transferred may not be honored by the insurance companies that issued them. Policies may still be in their contestable periods. Term or group policies may be subject to subsequent contract changes. Viators may not have taken all necessary actions or obtained required approvals. Viators' surviving family members may contest changes in beneficiaries. In one Texas case, for example, the viator substituted his mother as beneficiary after he agreed to viaticate his life insurance policy. The viatical company was forced to seek payment of the death benefit through court action. *Eterna Benefits L.L.C. v. Hartford Life & Accident Insurance Co.*, 1998 WL 874296 *1 (N.D. Tex. Nov. 25, 1998). The bankruptcy of a viatical company can result in a total loss for investors. Alexander D. Eremia, *Viatical Settlement and Accelerated Death Benefit Law: Helping Terminal, But Not Chronically Ill Patients*, 1 DEPAUL J. HEALTH CARE L. 773, 777 (1997). Administrative fees charged on the contracts can be substantial – as much as thousands of dollars per policy – and these fees may not be disclosed. Eremia, *supra,* 1 DEPAUL J. HEALTH CARE J. at 784. Finally, little if any information may be available about the viatical companies and their principals, such as the length of time they have been in business, whether and where they are registered to do business, and any civil and criminal disciplinary histories they may have.

In short, while viaticals have helped some terminally ill people by providing them with funds they can use for medical expenses and other purposes before they die, these

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Assurance Co. v. Superior Court of Los Angeles County, 930 P.2d 1264 (Cal. 1997), the viator not only lied when he applied for the policy, but had his brother impersonate him at a physical exam.

benefits have come at a high price for investors. For this reason, NASAA seeks to ensure that these products are carefully regulated – not *prohibited* – for the benefit of public investors in Texas and elsewhere. Regulation of viatical investments as securities is generally regarded as a way to help "alleviate many of the problems inherent in the viatical settlement industry." Luxenberg, *Why Viatical Settlements Constitute Investment Contracts Within the Meaning of the 1933 & 1934 Securities Acts*, 34 WILLAMETTE L. REV. 357, 386 (Spring 1998). Mandatory registration of viatical settlement contracts and those who sell them give investors access to material information about the investments and the promoters. Because viatical settlement contracts are inherently risky investments, it is especially important that the risks associated with them be disclosed to the investing public. Registration is the only mechanism that can ensure this disclosure. The remedial and punitive sanctions that are available under securities statutes also help protect investors by halting illegal sales and deterring fraud, although these remedies provide relief largely after the fact. *See* Timothy P. Davis, *Should Viatical Settlements Be Considered "Securities" Under the 1933 Securities Act?*, 6 KAN. J. L. & PUB. POL'Y 75 (Winter 1977).

Texas securities law provides the full range of these safeguards to investors. Under the Texas Securities Act and the implementing regulations, securities must be registered. *See* TEX. REV. CIV. STAT. ANN. art. 581, § 7; State Sec. Bd., 7 TEX. ADMIN CODE § 101.1 *et seq*. Before they can be registered, they are reviewed to ensure that investors have access to full and fair disclosure of all relevant investment information, including whether materials related to proposed offerings are fair, just, and equitable. *Id.*

at §§ 7, 9(C). The review also is designed to ensure that conflicts of interest are minimized and that promotional expenses, including commissions, are reasonable. *Id.* at § 9(B).

As long as viatical settlement contracts are declared to be securities under Texas law, then sellers must be registered as well. Registrants must submit to extensive background examinations and pass competency tests covering the law and ethical practices. Dealers must meet standards of conduct and financial solvency, and must not have a history of inequitable or fraudulent business practices. *Id.* at §§ 12-14. The Texas Act, of course, also prohibits the use of fraud or misrepresentation in the offer and sale of securities. *Id.* at §§ 9(C), 22.

Texas also imposes a broad array of sanctions for securities violations. They include license suspension or revocation, *id.* at § 14; cease and desist orders, *id.* at § 23; administrative fines, *id.* at § 23-1; and receiverships, *id.* at § 25-1. Stiff criminal penalties apply to violations of the Act. The Act criminalizes not only fraud, but also the registration violations – failure to register as a dealer or agent, and failure to register the securities themselves. *Id.* at § 29(A), (B). One of the most important remedial provisions in the Texas Act gives investors the right to sue for rescission if they have been sold an unregistered security. *Id.* at § 33(A). NASAA has an interest in seeing that the citizens of Texas continue to receive all of these protections, and it therefore supports the continued regulation of viaticals as securities.[3]

[3] It is vital that the Texas Securities Act continue to apply to viaticals because there simply is no other regulatory scheme that gives investors the same protections. No other Texas statute or set of regulations requires the registration of investment products, the testing and licensing of sales representatives, and the mandatory disclosure

II. **Promoting Uniformity**

Seeking to overturn the lower court's ruling also supports the cause of investor protection nationwide. A decision in favor of the Plaintiff will set a valuable precedent that, while not binding outside Texas, will nevertheless help guide other state courts in the direction of investor protection. This is particularly important in light of the D.C. Circuit's opinion in *SEC v. Life Partners*, *Inc.*, 87 F.3d 536 (D.C. Cir.), *rehearing denied*, 102 F.3d 587 (D.C. Cir. 1996), an unsound and widely criticized case holding that certain viatical settlement contracts are not securities under federal law. That case has, for the time being at least, hampered the regulation of viaticals as securities at the federal level. In the interest of preserving the regulation of viaticals on the state level, NASAA seeks to properly minimize the impact of the *Life Partners* decision.

Uniformity is important for another reason: it not only maximizes investor protection nationwide, it also promotes fairness. It helps ensure that the citizens of every state receive investor protection in roughly equal measure, so that no state becomes a preferred haven for financial fraud. The vast majority of states regulate viatical settlement contracts as securities. Forty-one states do so under an investment contract

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of risks and other information about securities. These measures are unique in affording protections to investors *before* they part with their money. Although other Texas statutes punish some fraudulent conduct, those remedies apply more narrowly and offer fewer remedies. For example, the "Fraud" chapter of the Texas Business and Commerce Code prohibits fraud, but only with respect to transactions in real estate or "stock in a corporation or joint stock company," *see* V.T.C.A., BUS. & C. CODE § 27.01 *et seq*. (Vernon 1987 & Supp. 2002) (Fraud) § 27.01. Moreover, that provision is narrower in scope than the fraud prohibition under the Texas Securities Act. *See* Keith A. Rowley, *The Sky is Still Blue in Texas: State Law Alternatives to Federal Securities Remedies*, 50 BAYLOR L. REV. 99, 171 (1998). The Texas Securities Act imposes criminal sanctions, *see* TEX. REV. CIV. STAT., ANN. art. 581,, § 29; and the civil penalties under the Texas Securities Act are substantially heavier than those available under the Texas Deceptive Trade Practices Act. *Compare* TEX. REV. CIV. STAT. ANN. art. 581, § 23-1, *with* V.F.T.C.A., BUS. & C. CODE § 17.47 (civil penalties are commensurate with Securities Act fines only where victims are over 65).

analysis, and four states do so under an explicit statutory definition that defines securities to include viatical settlement contracts. *See* Affidavit of Syver Vinje, attached to Plaintiff's Response and Objection to Defendant's Motion for Summary Judgment and Plaintiff's Cross-Motion for Summary Judgment and Brief in Support (II C.R. 241) (hereafter cited as "Plaintiff's Response and Objection") as Exhibit 9.

The Texas Securities Board has been regulating viaticals as securities for years, in accordance with its mandate to protect investors, *see* TEX. REV. CIV. STAT. ANN. art. 581, § 10-1(B).[4] Within just the last three years, Texas has brought a number of administrative and criminal actions alleging violations of the Texas Securities Act in connection with the sale of viatical products. *See, e.g., State v. Sharon June Hutchison*, Nos. 0818567/0818606 (Dec. 7, 2001 and Jan. 15, 2002), District Court of Tarrant County (defendant convicted on 10 counts of selling securities without a license – including $2 million of fraudulent viatical contracts – and sentenced to 9 years in prison); *State v. Michael Lee Davis*, Nos. F-99-99980-RL, F-99-99981-RL, F-99-9982-RL, F-99-99983-RL, F-99-99984-RL, and F-99-99985-RL (2000), District Court of Dallas County (defendant sentenced to six 60-year prison terms and ordered to pay $5.6 million in restitution for defrauding scores of elderly investors and more than a dozen insurance companies in a scheme involving viatical settlement agreements); *State v. Sherry W. Keisling*, Nos. CR-26153 and CR-26154 (2001) District Court of Midland County (defendant pled guilty to violating Texas Securities Act in connection with the sales of

[4] Maximizing coordination with other states' laws also is one of the stated purposes of the Texas Securities Act. *See* TEX. REV. CIV. STAT. ANN. art. 581, § 10-1(A).

certificates of viaticated insurance benefits, was ordered to pay $113,000 in restitution and placed on ten years probation); *In the Matter of American Benefits Services, Inc. and R. Ray Levy*, State Securities Board Docket No. 99-037, Order No. CDO/FIN - 1366 (June 11, 1999) (respondents ordered to cease and desist from the offer and sale of investment contracts and evidences of indebtedness related to viaticated insurance policies until such securities are registered or an available exemption is applied); *In the Matter of ALI Viatical Funding, Inc.*, State Securities Board Docket No. 99-038, Order No. SSO/FIN – 1367 (June 28, 1999) (Disciplinary Order requiring ALI Viatical Funding, Inc. not to further violate the Texas Securities Act and to pay a fine of $10,000 to the State of Texas).

One important effect of these actions has been sending a message of deterrence to other companies that might consider selling in – or relocating to – Texas. The lower court's ruling threatens to eliminate this deterrent in Texas. A judicially created gap in Texas securities law will attract financial predators who have been turned away by the majority of other states that continue to regulate viaticals as securities. Unethical viatical companies will prey upon the citizens of Texas to a disproportionate degree, viewing them as relatively safe targets of fraud and abuse. By its terms, the Texas *Insurance Code* does not apply to those who invest in viatical settlement contracts, and it therefore does not fill this regulatory vacuum. By promoting uniformity, NASAA is helping to prevent each state from becoming a preferred target of fraud and abuse.

STATEMENT OF FACTS

Plaintiff Griffitts is a 70-year-old retiree with a high-school education. During the time period relevant to this case (1997 and thereafter), her income consisted of Social Security benefits and approximately $885 paid quarterly on an annuity. She had no experience with any investments apart from her annuity. (IV C.R. 709-710).

In 1997, Defendant Life Partners was in the business of selling viatical investments to the public. (II C.R. 293). These investments were whole or fractionalized interests in the death benefits to be paid under life insurance policies of terminally ill individuals known as viators. (II C.R. 277).

Late in 1997, sales agents licensed by Life Partners persuaded Griffitts to invest in two viatical settlement contracts in amounts totaling $27,752.97. (II C.R. 315, 318-25). In promotional literature given to Griffitts, Life Partners characterized the investments as an opportunity to receive a high potential profit while exposing principal to low risk. (II C.R. 291). Life Partners' sales documents indicated an historical rate-of-return of 18% annually. (II C.R. 277, 281-2).

Life Partners structured Griffitts' investments in the form of two notes issued to her Individual Retirement Account ("IRA"). The notes were collateralized by fractionalized interests in death benefits to be paid under the life insurance policies of two individuals represented to be terminally ill with AIDS. (II C.R. 315, 318-25).

Griffitts played no role in evaluating or selecting either the ailing viators whose life insurance policies were being viaticated or the policies themselves, nor did she play any role in managing or overseeing the investments. Although she signed Life Partners'

standard-form contract indicating she was a knowledgeable investor, she had no experience with viatical investments, no affiliation with any insurance company, and no investment experience of any kind other than her annuity. In every aspect of the investment, Griffitts relied completely on Life Partners and the agent designated by Life Partners, the Sterling Trust Company ("Sterling Trust"). (II C.R. 316, 327-7; IV C.R. 709-10).[5]

In general, Life Partners not only structured these investments, but also carried out all of the functions necessary to manage them. Life Partners identified potential viators, evaluated their health, estimated their life expectancies, confirmed the validity of their insurance coverage, negotiated with viators to obtain the rights to their death benefits, converted group policies to individual policies where necessary, confirmed that beneficiaries were properly re-designated by viators, monitored the health of viators, and when called upon, assisted investors in finding a secondary market for the investments. (II C.R. 279, 295, 297, 299, 302, 309).

Life Partners performed other critical functions through Sterling Trust. Sterling Trust served as the custodian of documents, acted as escrow agent, paid a set percentage fee to Life Partners to cover its costs and profit, and forwarded premiums on policies. (II C.R. 277, 292, 316, 334-38). It was also Sterling Trust's responsibility, upon the death of

[5] Life Partners and Sterling Trust were closely affiliated. For example, the form documents prepared by Life Partners listed Sterling Trust as the designated agent. *See, e.g.,* Beneficiary Designations of William O'Connor and Philip Archer, Attached to Answers to Second Set of Interrogatories and Requests for Production of Documents, Plaintiff's Response and Objection, *supra*, Exhibit 6. In addition, a former president of Sterling Trust became the president of Life Partners. *See* "The Life Partners Approach" in Joseph C. Long, 12 BLUE SKY L. § 2A.02[1][a].

a viator, to file the death claim and collect and distribute the death benefits. Life Partners itself assumed no risk in connection with Griffitts' investment.

From the time of her initial contact with Life Partners and thereafter, Griffitts remained passive with respect to her investment. In March of 2000, when premium payments fell into arrears on one of her viatical investments because the amount reserved for premium payments was depleted, Life Partners notified Griffitts that she personally needed to pay $379.01 in additional funds in order to prevent lapse of one of the insurance policies whose benefits collateralized the notes to her IRA. (II C.R. 316, 342). She paid that amount.

Neither Life Partners, nor its agents, nor the viatical settlement products it sold to Griffitts have ever been registered with the Texas Securities Board. (III C.R. 509).

SUMMARY OF THE ARGUMENT

The viatical settlement contracts sold to Griffitts are securities because they are investment contracts under the *Howey* test as applied in Texas. Those contracts involved (1) the investment of money, (2) in a common enterprise, (3) with the expectation of profits, (4) through the efforts of others. The D.C. Circuit's decision in *SEC v. Life Partners, Inc.*, 87 F.3d 536 (D.C. Cir.), *rehearing denied*, 102 F.3d 587 (D.C. Cir. 1996), which focuses exclusively on post-investment promoter efforts, does not change this result. That decision is not binding on this Court and it has been widely and deservedly criticized by courts and scholars as an anomalous and arbitrary departure from the precedents and principles of securities law. Pre-investment promoter efforts can be just

as critical as post-investment efforts – and in some instances more critical – in determining the future profitability of an investment, and investors need the protections of securities regulation regardless of when they invest in relation to promoter efforts. In any event, even under the D.C. Circuit's flawed test, the post-investment efforts of Life Partners were sufficiently entrepreneurial to satisfy the "efforts of others" requirement for investment contracts.

The Texas Securities Board has exercised jurisdiction over viatical contracts for years under an investment contract analysis, and as the regulatory agency responsible for interpreting and enforcing the Texas Securities Act, its position deserves deference. A survey of all states confirms that viatical contracts are properly regarded as investment contracts: forty-five states regulate viatical settlement contracts as securities, forty-one under an investment contract analysis and four under explicit statutory language.

The contracts sold to Griffitts are securities for another, independent reason: they were structured as notes, which are presumed to be securities under Texas law. Under the facts of this case and the test for a note under *Reves v. Ernst and Young*, 494 U.S. 56 (1990), as applied in Texas, that presumption cannot be overcome. The motivations of the buyer and seller to raise money and to derive profit, the broad plan of distribution, the public's reasonable perception that securities were being offered, and the absence of any meaningful risk-reducing factors all confirm that these notes are securities.

The insurance exclusion in the Texas Securities Act does not apply to the contracts at issue. The wording of the exclusion is plain: it only covers insurance policies or related instruments that have been issued by an insurance company. The contracts sold to

Griffitts are neither. They are not insurance policies (nor are they the type of related instruments contemplated by the exclusion), and they certainly were not issued by an insurance company. Moreover, applying the exclusion in this case would violate the rationale for the provision. The exclusion was intended to apply only to instruments that are subject to regulation by the Texas Department of Insurance. The Texas Department of Insurance does not regulate viatical settlement contracts purchased by investors: the Texas viaticals statute is carefully limited to transactions between viatical companies and viators, not investors. The Texas Department of Insurance offers no protection to those who invest in viatical settlement contracts.

Finally, reversing the lower court is sound policy as well as sound law. A decision in favor of regulating viatical settlement contracts as securities strikes the right balance between protecting investors and serving the needs of the terminally ill. Griffitts is not seeking a ban against the sale of viatical settlement contracts. Rather, she is asking that these investments be properly recognized as securities under Texas law so that they are subject to registration and licensing requirements. These and other provisions of the Texas Securities Act provide investors with meaningful protections and remedies, including rescission for registration violations and damages for fraud. Such protections are especially important with respect to viatical contracts and other investment products that are, by their nature, effective instruments of fraud. If this Court rules in Griffitts' favor, as it should, the terminally ill and the elderly in need of funds will still have a market for their insurance policies, but not at the expense of important investor protections under the Texas securities law.

ARGUMENT

I. The Viatical Settlement Contracts Sold to Griffitts Are Securities Because They Are Investment Contracts and Because They Are Notes

The viatical contracts sold to Griffitts are securities under Texas law on at least two independent grounds. First, they are investment contracts under the test set forth in *Howey*, and second, they are notes under the test set forth in *Reves*.

A. The Contracts Sold to Griffitts Are Investment Contracts

Section 4 of the Texas Securities Act defines a "security" to include an "investment contract." TEX. REV. CIV. STAT. ANN. art. 581, § 4.A. In determining whether a financial instrument is an "investment contract," the courts in Texas apply the four-pronged test established by the United States Supreme Court in *SEC v. W. J. Howey Co.,* 328 U.S. 293 (1946). *See Searsy v. Commercial Trading Corp*., 560 S.W.2d 637, 640 (Tex. 1977); *Melton v. Keisling*, MO: 99-CA-145 (W.D. Tex. May 6, 2000), attached to Plaintiff's Response and Objection (II C.R. 241) as Exhibit 16.

The four elements of the *Howey* test are: (1) the investment of money (2) in a common enterprise (3) with the expectation of profits (4) through the efforts of others. Most federal courts have adopted the more flexible interpretation of *Howey* established in *SEC v. Glenn W. Turner Enterprises, Inc.* 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973). Under *Turner*, in order for an investment to be deemed a security, profits must come substantially, but not necessarily solely, from the efforts of others. *Id.* at 482.

The Supreme Court emphasized in *Howey* that its definition of a security "embodies a flexible rather than a static principle, one that is capable of adaptation to

meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." *Howey*, 328 U.S. at 299. In analyzing an investment, "form is to be disregarded over substance and the emphasis should be on (the) economic reality" of the transaction. *United Housing Foundation, Inc. v. Forman,* 421 U.S. 837, 848 (1975); *see also* Luxenberg, *supra*, 34 WILLAMETTE L. REV. at 374. Courts are to examine the economic reality and the totality of the circumstances surrounding the investment. *Glen-Arden Commodities, Inc. v. Costantino,* 493 F.2d 1027, 1034 (2nd Cir. 1974). Further, the Supreme Court has admonished that remedial legislation such as the securities law should be broadly construed to effectuate its purpose. *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967).

Measured by the *Howey* test and these interpretive guidelines, the viatical settlement contracts offered and sold to Griffitts by Life Partners are investment contracts.

1. Customers Invested Money

Howey first requires that there has been an investment of money. In the present case, investors sent a minimum of $5,000 to Life Partners for the right to receive all or a portion of the benefits payable upon the death of one or more viators. "Informal Guide to Understanding Limited Life Settlements," attached to Plaintiff's Response and Objection (II C.R. 241) as Exhibit 1.

Life Partners characterized its program as an alternative to the stock market, and suitable for retirement funds. In marketing materials, it described the benefits of the program with phrases such as "limited risk of principal," "avoid the volatility of the stock

market," and "ideal for qualified funds" such as retirement plans. Its "Informal Guide to Understanding Limited Life Settlements" also contained numerous references to participants in its program as "investors." *Id.* Without question, those purchasing Life Partners' viatical products were making an investment of money.

2. <u>There Was a Common Enterprise</u>

The second prong of the *Howey* test requires that the investment involve a "common enterprise." The term "common enterprise" denotes a "dependence by one party for his profit on the success of another in performing his part of the venture." *SEC v. Glenn W. Turner Enterprises, Inc.,* 474 F.2d at 482, n. 7; *McClellan v. Sundholm,* 574 P.2d 371 (Wash. 1978). In this case, there are at least two separate forms of commonality recognized by courts interpreting *Howey*: horizontal commonality and broad vertical commonality.

The horizontal commonality test is universally accepted among those states that apply *Howey.* It exists when the fortunes of each individual are tied to the fortunes of other investors "by the pooling of assets, usually combined with the pro-rata distribution of profits." *Revak v. SEC Realty Corp.,* 18 F.3d 81, 87 (2nd Cir. 1994). In the present case, horizontal commonality is established because Life Partners generally pooled investor funds to purchase the right to receive the proceeds of an insurance policy. Consummating an investor's purchase was dependent upon an aggregation of multiple investors' money to acquire the right to receive 100 percent of an insurance payout. The closing with a particular viator could not occur until sufficient funds were received from multiple investors to make the purchase. Further, investors shared proportionately in the

outcome of the investment: any profits or losses relating to a particular insurance policy accrued to all of the investors who purchased a right to the death benefits of that policy. This pooling of assets establishes horizontal commonality and the existence of a common enterprise.[6]

Some courts, including those in Texas, also recognize a distinct form of commonality, known as vertical commonality, for purposes of finding the requisite "common enterprise" under *Howey*. *See, e.g., Searsy v. Commercial Trading Corp.*, 560 S.W. 2d 637, 640 (Tex. 1973) ("the more recent weight of authority" permits a showing of vertical commonality to satisfy the common enterprise test). Vertical commonality focuses on the relationship between the promoter and the investor: it requires that "the investor and the promoter be involved in a common venture without mandating that other investors also be involved in that venture." *Hector v. Wiens,* 533 F.2d 429, 433 (9th Cir. 1976). Under the variation known as broad vertical commonality, the fortunes of the investors must be linked to the *efforts* of the promoter, but there need not be a sharing of profits and risks between the promoter and the investors. *See Revak v. SEC Realty Corp., 18 F. 3d* at 88; *see also Searsy v. Commercial Trading Corp.*, 560 S.W. 2d at 640 (vertical commonality found where ability of customers to collect profits from commodity options trading depended upon promoter's hedging efforts).

In this case, there was broad vertical commonality, in addition to horizontal commonality, because investors were dependent upon the efforts of Life Partners for their

[6] In general, viatical settlement contracts can be offered through a variety of pooling or fractionalizing techniques, all of which support a finding of horizontal commonality. *See* Long, 12 BLUE SKY L. § 2.05[2][b][iii].

profits. Life Partners had to use its expertise to locate and select appropriate viators in order for investors to receive the projected returns. Life Partners also had to evaluate policies to ensure they were valid and suitable for assignment, and it had to negotiate with each viator for the right to receive policy proceeds in exchange for a discounted payment. In addition, in order for investors to receive any returns, Life Partners or Sterling Trust had to monitor each viator's medical condition, make premium payments, file claims for benefits with insurance companies when viators died, and collect and disburse death benefits. *See* "Informal Guide to Understanding Limited Life Settlements," attached to Plaintiff's Response and Objection (II C.R. 241) as Ex. 1; "Understanding Life Partners' Underwriting Criteria," attached to Plaintiff's Response and Objection (II C.R. 241) as Exhibit 3; "Underwriting Criteria," attached to Plaintiff's Response and Objection (II C.R. 241) as Exhibit 4. In short, the investor's fortunes were inextricably tied to the efforts of Life Partners, thereby establishing broad vertical commonality.

3. Investors Expected A Profit

The third prong of the *Howey* test requires the "expectation of profits." In a securities transaction, "a person invests his money . . . and is led to expect profits" from the efforts of others; it is not a purchase for personal consumption or personal use. *Howey*, 328 U.S. at 299. This characteristic distinguishes a securities investment from an ordinary commercial transaction. *See United Housing Foundation v. Forman*, 421 U.S. at 858.

In the present case, investors purchased viatical settlement contracts because of the prospect of a substantial profit or return on the funds invested, and for no other reason. At the time of the investment, the unmatured death benefits could not be consumed as one might consume a commodity. The investors could not put their rights to receive future death benefits to personal use. They were simply entitled to receive their pro-rata share of the death benefits from Life Partners through Sterling Trust.

A seller's characterization of a product as described in its sales literature has long been considered appropriate in determining whether, in fact, the interest is a security. Joseph C. Long, 12 BLUE SKY LAW § 2.05(c)(iv)(B)(V). The sales materials distributed by Life Partners strongly emphasized the substantial returns that could be expected from the purchase of a viatical settlement contract. The investor was encouraged to compare the viatical settlement contract with other types of investments, such as stocks, bonds, or mutual funds, in terms of risk and expected profit. The viatical settlement contract was promoted as offering the least amount of risk while generating the greatest amount of profit. Life Partners enticed customers with "Profitability" as follows:

> The investor can enjoy the potential of a greater than market yield on invested money because they have purchased a life insurance policy that is worth much more than their investment. Life Partners' investors have seen an average annualized rate of return of about 18%.

"Informal Guide to Understanding Limited Life Settlements," *supra*, at 7.

The investors' motivations and the claims made by Life Partners clearly indicate that the third prong of the investment contract analysis, the expectation of profits, is satisfied.

4. Profits Derived from the Efforts of Others

The fourth prong of the *Howey* test involves an analysis of "whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which effect the failure or success of the enterprise." *Glenn W. Turner,* 474 F. 2d at 482. Those efforts have been defined to include both managerial and entrepreneurial efforts. *See Forman,* 421 U.S. at 852.

Life Partners performed an extensive array of managerial functions throughout the duration of each viatical settlement contract, and those efforts were critical to the success of the investment. After identifying viators, qualifying them, negotiating with viators for the purchase of insurance policy benefits, and selling fractional interests in viatical settlement contracts to investors, Life Partners or its agents continued to perform services on behalf of the investors. These included monitoring the health of each viator, ensuring that policies did not lapse, converting group policies into individual policies as necessary, and attempting to arrange for resale of investors' interests when so requested. Life Partners' Answers to Second Set of Interrogatories and Request for Documents, attached to Plaintiff's Response and Objection (II C.R. 241) as Exhibit 6, Answer No. 10.

After purchase, Sterling Trust – the agent designated by Life Partners – acted as custodian of policies, funds, and documents; served as escrow agent; paid premiums; and filed necessary paperwork. "Informal Guide to Understanding Limited Life Settlements," *supra,* at 3. Life Partners itself regularly advised Griffitts of the health status of each insured and collected additional funds from Griffitts to cover a premium shortfall.

Affidavit of Bobbie J. Griffitts, attached to Plaintiff's Response and Objection (II C.R. 241) as Exhibit 7.[7]

Generally, investors did not have the expertise to perform these described functions, particularly estimating the life expectancy of a viator and monitoring and evaluating a viator's health status. In addition, investors were unable to perform many of these functions because their access to the necessary medical records was restricted. Each purchaser of a viatical settlement contract relied completely on Life Partners and its agents to perform the pre-investment and post-investment services that were necessary for investors to achieve any returns. All profits that were to be made by a purchaser of a viatical settlement contract were derived through the efforts of Life Partners or its agents, and the fourth prong of the *Howey* test is therefore satisfied.[8]

5. <u>The Decision in SEC v. Life Partners</u>

The D.C. Circuit's decision in *SEC v. Life Partners* does not change this conclusion. *See SEC v. Life Partners, Inc.*, 87 F.3d 536 (D.C. Cir.), *rehearing denied*, 102 F.3d 587 (D.C. Cir. 1996). In that case, the U.S. Securities and Exchange

[7] Whether or not investors technically had a right to participate in these managerial activities is irrelevant. If, as a practical matter, investors relied heavily upon a promoter's advice, ability, and financial responsibility, the "efforts of others" test has been met. *See Searsy v. Commercial Trading Corp.*, 560 S.W.2d 637, 641 (Tex. 1973) (finding "efforts of others" test met where investors had the legal right to participate in trading but were not required to do so and seldom did).

[8] Life Partners relies heavily on two Texas cases: *McConathy v. Dal Mac Commercial Real Estate*, 545 S.W.2d 871 (Tex. Civ. App. – Texarkana 1976, no writ), and *Wilson v. Lee*, 601 S.W.2d 483 (Tex. Civ. App. – Dallas 1980, no writ). Both involved investment in parcels of land. In each instance, the courts held that the seller's operational, managerial, or developmental efforts were insufficient to meet the *Howey* test. However, the promoters' efforts in those cases were much less extensive and significant than the efforts expended by Life Partners in connection with Griffitts' investment. This case hardly involves merely purchasing land and waiting for it to appreciate. The Life Partners arrangement is more analogous to the type of real estate offerings that **are** deemed to be securities under Texas law, where investors purchase fractionalized interests in a property or properties and the trustee performs specific management services on their behalf. *See, e.g.,* Administrative Guidelines for Registration of Real Estate Investment Trusts, State Sec. Bd., 7 TEX. ADMIN. CODE § 143.

Commission ("SEC") sought to enjoin Life Partners from selling viatical settlement contracts similar to those at issue here, arguing that they were unregistered investment contracts under *Howey*. The United States District Court for the District of Columbia held that the instruments were investment contracts, s*ee SEC v. Life Partners, Inc.*, 898 F.Supp. 14 (D.D.C. 1995), but the Court of Appeals reversed. In a 2-1 decision and over a strenuous dissent, the D.C. Circuit held that all elements of the investment contract analysis were satisfied except one, the "efforts of others" test. In a striking and unwarranted departure from the case law and the policies underlying securities regulation, the court adopted an arbitrary, bright-line test and modified the fourth prong of the *Howey* test to eliminate from consideration the pre-purchase efforts of the promoter. 87 F.3d at 545. The court also held that the actions taken by Life Partners *after* the time investors parted with their money were only "ministerial" and therefore insufficient to constitute the "efforts of others" for purposes of *Howey*. *Id.* at 548.

The *Life Partners* decision has been widely criticized by courts and scholars for establishing a test that has no authoritative support or rationale. States courts have been emphatic in their rejection of the decision. Nearly every state court to address the issue has refused to adopt the D.C. Circuit's analysis.[9] *See Alabama v. Kash*, Case Nos. CC-00-25, 26, & 27 (Ala., St. Clair Co. Cir. Ct., July 14, 2001); *Siporin v. Carrington*, 23 P.3d 92 (Az. App. Div. 1, April 19, 2001); *Hill v. Dedicated Resources*, Case No. 99-C-

[9] NASAA's research reveals only one case in which a state court adhered to the D.C. Circuit's ruling in *SEC v. Life Partners*. *See Decker v. Mutual Benefits Corp.*, Case No. 00-0541-CA-17 (19th Judicial Circuit, River County, Fla. May 17, 2001) (Order on Motion to Dismiss). The court's conclusions of law suggest that it felt compelled to follow federal caselaw, citing language from the Florida Supreme Court to the effect that the Florida legislature

1714 (Kan., Shawnee Co. Dist. Ct. 6, July 12, 200 and Jan. 3, 2001); *Michelson v. Voison*, No. 00-0355186-CK-5 (Mi., Saginaw Co. Cir. Ct., Feb. 2, 2001); *Oklahoma Department of Securities v. Accelerated Benefits Corp.*, No. CJ-99-2500-66 (Okla. Co. Dist. Ct., June 26, 2001); *Landau v. Sheaffer*, Case No CI-00-04672 (Pa. Ct. of Common Pleas, Lancaster County, June 22, 2001). And in each of these cases, the courts were interpreting statutory definitions similar to the one in Texas. *See* ALA. CODE § 8-6-2(10) (1975); ARIZ. REV. STAT. ANN. § A44-1801(26) (2001); KAN. STAT. ANN. § 17-1252(j) (Furse 2000); MICH. COMP. LAWS § 451.801(z) (2001); OKLA. STAT. tit. 71 § 2(v) (1991 & Supp. 1998); 70 P.S. § 1-102(t). These cases and other lines of authority highlight two fundamental flaws in the *Life Partners* decision: the D.C. Circuit adopted an erroneous test, and then proceeded to misapply it.

a. The *Life Partners* Test Is Wrong

In the first instance, by focusing exclusively on promoter efforts after investment, the D.C. Circuit adopted an irrational standard that lacks authoritative support. In the words of the court in *Alabama v. Kash:*

> [T]his Court expressly rejects the decision of the Circuit Court of the District of Columbia in *SEC v. Life Partners* . . . . The *Life Partners* decision is based upon flawed logic and is without case precedence. It establishes a "bright line rule" that "whatever the surrounding circumstances, an investment is not a security unless significant managerial activities by the promoter occur post-purchase." [citation omitted]. No Court before *Life Partners,* nor since, has ever read into the fourth prong of the *Howey* test a requirement that the efforts of others generating profits of others must be expended after the purchase of the investment. To ignore the significant pre-purchase efforts made by the viatical company is simply illogical. [*citing* the *Siporin* case, *infra*]

"intended Florida securities law to be *hand-in-glove* with federal securities law." *Id.* at 2 *(quoting Oppenheimer v. Young*, 456 So. 2d 1175, 1178 (Fla. 1978)) (emphasis added).

Alabama v. Kash, supra, at 3 (holding viatical settlement contracts to be securities).

The court in *Landau v. Sheaffer* also squarely rejected the narrow focus on post-investment efforts adopted in *Life Partners:*

> In essence, *Life Partners* holds that activity before the sale of the viatical investment contract does not constitute the 'efforts of others' requirement for the third prong of *Howey*. In my view, this approach ignores the purposes of the Securities Act. Further, [the] *Life Partners* holding as applied to this case would elevate form over substance . . . .

Landau v. Sheaffer, supra, at 11.

And the court in *Oklahoma Dept. of Securities v. Accelerated Benefits Corp.* similarly repudiated the *Life Partners* holding:

> The *Life Partners* case places its emphasis on the managerial efforts of the seller of the investment at the point of post investment. As here, the Defendant argues that the only managerial effort by ABC after the investor's purchase is the payment of proceeds at [the death] of the viator. This analysis is inconsistent with the test set forth in *U.S. v. Howey,* 328 U.S. 293 (1946). The outcome of the investment in the instant case is totally dependent on the expertise and managerial efforts of ABC in seeking out and choosing the right viatical settlement. Investors have no input into the investment . . . .

See Oklahoma Dept. of Securities v. Accelerated Benefits Corp., supra, at 8-9.

The federal bench also has shown an inclination to reject the *Life Partners* test. The United States District Court for the Western District of Texas addressed the issue in *Melton v. Keisling*, MO:99-CA-145 (W.D. Texas, May 16, 2000). The court cast doubt on the validity of the *Life Partners* decision, and on that basis denied a viatical promoter's motion to dismiss. Although not prepared to reject the *Life Partners* analysis in its entirety, the court agreed with the plaintiffs in that case about the importance of the defendants' pre-purchase activities:

> [T]he Plaintiffs argue convincingly that the Defendants' Motion to Dismiss should not be granted because the return on viatical settlements is so dependant upon the accuracy of the promoter's prediction of the viator's life expectancy. The Court agrees that the return on a viatical settlement does not depend solely on the death of the viator but rather on the accuracy of the promoter's assessment of the viator's life span, a prediction that is made pre-purchase.

Melton v. Keisling, *supra,* at 8. The court deferred decision on the ultimate issue of whether the "efforts of others" test was satisfied based on the record before it, but implicit in the court's analysis is an acknowledgement that pre-purchase activities of a promoter can satisfy the *Howey* test.

In fact, there is a long line of decisions in which courts have held that pre-investment efforts alone are sufficient under *Howey,* such as where a manager uses special expertise to select items within a particular class that have greater value than other items within that class or that will appreciate at a rate higher than other items within the class. Thus, a promoter may use his expertise to select for investors particular scotch whiskeys, stamps, coins, embryos, and diamonds that will increase at a rate higher than average items in these classes. *See, e.g., Bailey v. J.W.K. Properties, Inc.,* 904 F.2d 918 (4th Cir. 1990) (embryos for cattle breeding); *Glen-Arden Commodities, Inc. v. Costantino*, 493 F. 2d 1027 (2nd Cir. 1974) (scotch whiskey); SEC *v. Haffenden-Rimar Int'l, Inc,* 496 F.2d 1192 (4th Cir. 1974) (scotch whiskey); *SEC v. Brigadoon,* 388 F.Supp. 1288 (D. N.Y. 1975) (rare coins).

In these cases, the investors passively relied upon the promoters to select appropriate items in which to invest. *SEC v. Brigadoon* is representative. The investors deferred to the company's expertise in selecting rare coins for investment and had no

further obligation to subscribe to any post-purchase services. The court held that under these circumstances, the company's sale of rare coins to investors constituted the sale of investment contracts. 388 F.Supp. at 1293. Whether any of the company's post-purchase services affected the value or price of the coins was deemed irrelevant since the coins' "selection is the most crucial factor in determining how much profit an investor in coins will make." *Id.* This reasoning applies to the selection of viators and their policies just as it does to the selection of scotch whiskeys, stamps, coins, and diamonds.

The test adopted in *Life Partners* conflicts not only with the caselaw discussed above, but also with the fundamental rationale for securities regulation, which is mandatory disclosure of meaningful information for the protection of investors. In the words of Judge Wald, who vigorously dissented from the *Life Partners* decision:

> [W]hat the investor needs to know is . . . what the specific risk factors attached to the investment are and whether there is any reason why the investor should be leery of the promoter's promises. This need for information holds true in regard to investors prior to purchase as much as to investors who have committed their funds – indeed more so, if they are to avoid over-risky investments.

SEC v. Life Partners, 87 F3d at 552.

Adopting the rigid pre-purchase/post-purchase distinction put forth by the D.C. Court of Appeals in *Life Partners* ignores this important policy of investor protection and results in an inflexible and artificial approach to analyzing an investment. Indeed, such a restrictive interpretation elevates the form of the transaction over its substance, contrary to the United States Supreme Court's admonition that remedial statutes such as the securities laws should be broadly construed to effectuate their purposes. *See Tcherepnin v. Knight,* 389 U.S. at 336.

Such an interpretation is also inconsistent with the underlying purpose of the Texas Securities Act, which is the protection of investors. *Thomas v. State*, 3 S.W.3d 89, 93 (Tex. App. Dallas 1999, no writ) (citing TEX. REV. CIV. STAT. ANN. art. 581, § 10-1(B)). In service of this goal, the Texas Securities Board regulates viatical settlement contracts as securities and has done so for years. (*See* the civil and criminal actions filed in Texas, *supra* at 11-12.) As the administrative agency responsible for interpreting and enforcing the Act, its position is entitled to deference. The United States Supreme Court "has often repeated the general proposition that considerable respect is due 'the interpretation given [to a] statute by the officers or agency charged with its administration.' " *Ford Motor Credit Company v. Milhollin*, 444 U.S. 555, 566 (1980), *quoting Zenith Radio Corp. v. U.S.*, 437 U.S. 443, 450 (1978) and *Udall v. Tallman*, 380 U.S. 1, 16 (1965). Similarly, the Texas Supreme Court has supported the premise that contemporaneous construction of a statute by the administrative agency charged with its enforcement is entitled to great weight. *State v. Public Utility Commission of Texas,* 883 S.W. 2d 190 (Tex. 1994); s*ee also Tarrant Appraisal District v. Moore*, 845 S.W. 2d 820 (Tex. 1993).

The Texas approach is consistent with the majority of state securities regulators throughout the country: forty-one states regulate viaticals under an investment contract analysis. Four additional states include viatical settlement contracts in the statutory definition of a security. *See* Affidavit of Syver Vinje, North Dakota Securities

Commissioner and Chair of the NASAA Viaticals Project Group, attached to Plaintiff's Response and Objection (II C.R. 241), as Exhibit 9.[10]

Thus, federal and state decisional authority, deference to administrative expertise, and sound policy all support the conclusion that the fourth element of the *Howey* test is met when, upon a review of the efforts of the promoter *as a whole*, the investor's realization of a profit depends substantially upon the managerial efforts of the promoter, regardless of the time at which such services are performed. Ample grounds exist for this Court to disregard the test set forth in *SEC v. Life Partners* decision and to hold that the viatical settlement contracts sold to Griffitts are, in fact, investment contracts.

b. The D.C. Circuit Misapplied Its Own Standard

The *Life Partners* decision suffers from another fundamental flaw. The D.C. Circuit failed to give sufficient weight to the managerial efforts that Life Partners expended after investors parted with their money. In essence, the court adopted an erroneous test and then proceeded to misapply it. The D.C. Circuit unduly trivialized the following functions and responsibilities of Life Partners, calling such activities "ministerial:" holding the policy for the duration of the insured's life, matching each investor to an insurance policy, making premium payments to avoid lapse of policies, monitoring the insured's health, filing the death claim, and collecting and distributing the death benefit. *See* 87 F.3d at 540; s*ee also* Long, *supra*, 12 BLUE SKY L. at § 2A.02(3)(d)(ii).

[10] The *Life Partners* decision has generated substantial legal commentary and, as the many articles cited in the text illustrate, the majority of scholars analyzing the case have found fault with it.

The Arizona Court of Appeals, the first state appellate court to consider viatical settlement contracts, was definitive in rejecting *Life Partners* on these grounds:

> We disagree with the court of appeals' analysis in Life Partners. Although Arizona courts have consistently been guided by the federal courts' interpretation of the 1933 and 1934 federal Acts when applying the Arizona Securities Act, we will not defer to federal case law when, by doing so, we would be taking a position inconsistent with the policies of our own legislature. We will depart from those federal decisions that do not advance the Arizona policy of protecting the public from unscrupulous investment promoters . . . . The mortality of the viator is merely another factor to be considered when the seller assembles a viatical settlement agreement that will, the parties hope, be profitable for the investor upon the inevitable death of the viator. *What truly determines viatical settlement profitability is the realization, over time, of an outcome predicted by the seller through its analyses of the viator's life expectance, the soundness of the insurer, the actions needed to keep the policy in effect for the original face amount, and the insurer's unconditional liability under the policy terms*.

Siporin v. Carrington, 23 P.3d at 98-99 (emphasis added);[11] *see also Alabama v. Kash*, *supra,* at 4-5 ("[T]he *Life Partners* decision wrongfully trivialized the post-purchase efforts of the viatical company. As previously noted, the post-purchase efforts are vital to the success of the viatical settlement investment."); *Hill v. Dedicated Resources, supra*, at 4 ("Both the pre and post purchase efforts in a typical viatical settlement are sufficient to satisfy the *Howey* test as interpreted by Kansas courts.")

Life Partners' continued efforts were especially critical to the success of the investment for early investors. The consummation of one investor's purchase was dependent upon Life Partners funding 100 percent of the cost to acquire the policy

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[11] Like several states, Arizona has adopted a statutory provision that expressly includes viatical settlement contracts within the definition of a security. That provision was in effect at the time of the *Siporin* decision, but it was *not* in effect at the time of the defendant's illegal conduct. Accordingly, in *Siporin*, the Arizona court relied on the *Howey* investment contract analysis, not the recently amended statutory definition, to render its decision. *See Siporin v. Carrington*, 23 P.3d at 95-96.

benefits. Efforts to sell the remaining interests in the policy proceeds necessarily occurred *after* an initial investor committed funds to the contract. These selling efforts were absolutely essential for the initial investor in the policy to realize any profit at all. Obviously then, at least as to early investors, more than just ministerial efforts remained to be performed.

Life Partners' other efforts in continually managing the investments were critical for *all* investors. Whether or not labeled as "ministerial," these acts were central to the realization of profits by investors. *See* Luxenberg, *supra*, 34 WILLAMETTE L. REV. at 384.[12] It was the responsibility of Life Partners, or its designated escrow agent, to determine the number of premium payments to be reserved in the special premium account and to make timely payments. Failure to make premium payments in a timely fashion would cause the policy to lapse and render the investment worthless. Life Partners defended against contestability claims and investors relied on Life Partners to maintain sufficient contacts with viators to determine the status of their health. In addition, the investors relied on Life Partners or its agent to file the death claim upon the viator's death, and to divide the proceeds among the appropriate investors when the death benefit was paid. Since the investor was neither the owner of, nor the beneficiary on, the policy, there was no contractual relationship between the investor and the insurance carrier. Only Life Partners, or its agent, could file the death claim, a prerequisite to the investor receiving a return of any kind on his or her investment. The success of the entire

enterprise was dependent upon the continued operations and financial stability of Life Partners and its agent.

The duties performed by Life Partners *after* the sale of the investment contract were actually similar in nature to those performed by a general partner of a real estate limited partnership. Real estate properties to be placed under management are, as here, usually selected *before* the partnership interests are sold. What the promoter does after the sale is collect rent, retire the debt, and maintain the property. These are the same kinds of tasks performed by Life Partners after the sale of viatical settlement contracts. Of course, it is settled law that real estate limited partnership interests are securities.

With respect to the viatical settlement contracts offered and sold to Griffitts, there was an investment of money in a common enterprise with the expectation of profits through the efforts of others. The viatical settlement contracts meet all aspects of the *Howey* test for "investment contracts," and are therefore securities under the Texas Securities Act.

B. The Notes Sold to Griffitts Are Presumed to Be Securities Under Texas Law and There Is No Basis for Rebutting This Presumption

The viatical settlement contracts sold to Griffitts were structured as notes, and notes are defined as securities under the Texas Act. *See* TEX. REV. CIV. STAT. ANN. art. 581, § 4. Under Texas law, every note is presumed to be a security and this presumption can only be overcome if the note is shown to meet certain criteria. *See Grotjohn Precise*

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[12] *But see* Shanah D. Glick, *Are Viatical Settlements Securities Within the Regulatory Control of the Securities Act of 1933?* 60 U. CHI. L. REV. 957 (Summer/Fall 1993) (the viatical settlement company's activities do not meet the *Howey* test because they are "only administrative in nature").

Connecxionnes International, SA v. JEM Financial, Inc., 12 S.W.3d 859, 868 (Tex. App.-Texarkana 2000, no writ).[13]

In determining whether a specific type of note overcomes the presumption, Texas Courts look to federal law for guidance. *See Grotjohn*, 12 S.W.3d at 868. The leading test under federal law was established by the United States Supreme Court in *Reves v. Ernst & Young*, 494 U.S. 56, 65 (1990). In *Reves,* the Supreme Court held that the "family resemblance" test is to be used in deciding whether a note is a security. Under the *Reves* test, the presumption that a note or promise to pay in the future is a security may be rebutted if the instrument bears a *strong* resemblance to an instrument on the judicially crafted list of notes that are not securities. *Id.* at 64-65, 67*; Holloway v. Peat Marwick Mitchell & Co.*, 900 F.2d 1485, 1487 (10th Cir.), *cert. denied*, 498 U.S. 958 (1990)

The specific types of notes that the Supreme Court has deemed **not** to be "securities" include:

[13] In *Life Partners,* the D.C. Circuit never applied the *Reves* test. Having erroneously concluded that the viatical settlement contract at issue was not a security under an investment contract analysis, it reasoned that the notes could not be securities because they did not fundamentally change the substance of the transaction. *See* 87 F.3d at 548. This approach in effect holds that every security must pass the investment contract test, thereby relegating all other instruments statutorily defined as securities to a subordinate status. This is a profound misinterpretation of securities law, one that is not followed in any jurisdiction. The Texas Act, like virtually all securities statutes, purposely expands the definition of a security to encompass notes and a host of other instruments, with varied characteristics, that have no necessary relationship to investment contracts. *See* TEX. REV. CIV. STAT. ANN. art 581, § 4. Notes are distinct instruments that are to be analyzed under the *Reves* analysis. Under *Reves*, the notes sold to Griffitts are securities.

The D.C. Circuit's analysis also rests on the questionable premise that the notes did not change the fundamental character of the transaction. Certainly, use of the notes materially altered the character of the transaction from the standpoint of the Internal Revenue Service, insofar as the notes permitted investors – apparently with the blessings of the IRS – to put their IRA funds into these viatical products.

> [T]he note delivered in consumer financing, the note secured by a mortgage on a home, the short-term note secured by a lien on a small business or some of its assets, the note evidencing a 'character' loan to a bank customer, short-term notes secured by an assignment of accounts receivable, or a note which simply formalizes an open-account debt incurred in the ordinary course of business. . . [and] 'notes evidencing loans by commercial banks for current operations.'

Reves, 494 U.S. at 65 (citations omitted).

The Court in *Reves* outlined four factors that determine whether a particular note bears a strong family resemblance to the types of notes that are not securities. Those four factors are: (1) the motivations of the buyer and seller; (2) the plan of distribution for the instruments; (3) the public's reasonable perceptions; and (4) whether there are any risk-reducing factors suggesting that the instruments are not securities. *See Reves,* 494 U.S. at 66-67. Under Texas law, a note need **not** satisfy all four tests to be considered a security. *See Grotjohn*, 12 S.W.3d at 869 (holding a note to be a security where only two of the four elements applied). In this case, however, the notes sold to Griffitts meet all four criteria and therefore are securities.

1. The Motivations of Seller and Buyer

The first test requires an analysis of the motivations that would prompt a reasonable seller and buyer to enter into the transaction. "If the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments and the buyer's interest is primarily in the profit the note is expected to generate, the instrument is likely to be a security." *Reves,* 494 U.S. at 66. However, "[i]f the note is exchanged to facilitate the purchase and sale of a minor asset or consumer good, to correct for the seller's cash flow difficulties, or to advance some other commercial or

consumer purpose, the note is less sensibly described as a security." *Id.* at 66. A note given in exchange for a personal loan exemplifies the kind of note that would tend not to be viewed as a security. *See Grotjohn*, 12 S.W.3d at 869.

The notes sold to Griffitts easily meet this first test. Life Partners sold the notes to raise money to finance substantial investments. Those investments were the rights to receive life insurance benefits payable upon the death of viators. Given the nature of Life Partners' business, selling the notes also constituted raising money for the general use of the business enterprise. Structuring, arranging, implementing, and managing viatical transactions was and is the core business of Life Partners. The revenue they used for these general business purposes – and for their own fees – was the money they raised from investors such as Griffitts through the notes. Certainly, the notes were not sold to facilitate the purchase of minor assets or consumer goods, or to finance some other ancillary commercial or consumer purposes. It is equally clear that the investors were motivated by the expectation of receiving profits through the notes.[14]

2. <u>The Plan of Distribution</u>

The second test examines the plan of distribution for the notes. *See Reves,* 494 U.S. at 66. All that need be shown is that the instruments were offered and sold to a broad segment of the public; the instrument need not have been traded on an exchange. *Id.* at 68. On the other hand, restrictions on transfer or the offer to a very small number

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[14] In the court below, Life Partners argued that for purposes of the *Reves* analysis, the motivation for selling the notes was compliance with federal tax law. This argument misconstrues the *Reves* test. *Reves* focuses on why the buyer and seller entered the transaction, not why they did so using a particular format for the transaction. There is simply no question in this case that Life Partners' motivation for selling the notes was to raise the revenue that was

of people would militate against classifying the notes as securities. *See Grotjohn,* 12 S.W.3d at 869.

The notes sold to Griffitts also meet this second test. Life Partners offered and sold these notes to large numbers of investors who were required to meet only basic qualifications. Moreover, the notes and accompanying security agreements bore no restrictions on assignment or transfer, and Life Partners actually offered to assist investors in re-selling the notes in a secondary market. The plan of distribution was amply broad to satisfy *Reves*.

3. <u>The Public's Reasonable Perceptions</u>

The third test evaluates the public's reasonable perceptions of the instrument. Where the public expectation is that the instrument is a security, a court may rule accordingly, even if the other three factors militate against such a view and even if an economic analysis suggests that the instruments are not securities. *See Reves,* 494 U.S. at 68; *Grotjohn,* 12 S.W.3d at 869. Where promissory notes are advertised as investments and nothing would lead a reasonable person to question this characterization, a court may classify the notes as securities. *See Reves,* 494 U.S. at 69.

In this case, Life Partners marketed the notes as investments, and nothing would have led a reasonable person to question this characterization. Under the *Reves* test as applied in Texas, this is sufficient by itself to justify classifying the notes as securities. To rebut this argument in the court below, Life Partners advanced two points: language in

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essential for running its viaticals business and earning a profit. Similarly, the investors' motivations were to receive profits.

their documents disclaiming that the notes were securities, and a presumption that investors would have been aware of the decision in *SEC v. Life Partners*. Both points are wrong. Self-serving characterizations contained in documents drafted by promoters and forced upon investors are time-honored tricks of the trade among those who sell investments of dubious legality. Promoters typically invoke these labels as a shield against regulatory action, but usually negate them with conflicting sales pitches and other marketing materials. If anything, such tactics lend credence to the view that what is being offered *is* precisely the thing being disavowed. For this reason, courts routinely reject disclaimers that conflict with actual sales practices.

As to Life Partners' second point, it is unreasonable to presume that an investor in Texas without legal training would be familiar with a decision rendered by a federal court located thousands of miles away on a point of law that challenges some of the best legal minds. If such a presumption were valid, then it would be equally valid to presume that the investor would also be aware of the intense criticism leveled at the *Life Partners* decision and would conclude – quite accurately as it turns out – that virtually all other courts would reject the ruling. In reality, it is far more likely that investors would be aware of media reports chronicling the efforts of *securities regulators* to regulate viatical contracts for the benefit of investors. *See, e.g.*, Bill Day, *Secure Against Scams; State Securities Board Officials Warn Seniors to Guard Their Investments*, San Antonio Express-News, May 1, 2001, WL 19784485.

4. Risk Reducing Factors

Finally, under *Reves*, courts must determine whether there are any risk-reducing factors suggesting that the notes are not in fact securities. *Reves,* 494 U.S. at 67. "*Reves* indicates that an alternative regulatory scheme, collateral, and insurance are all capable of reducing the risk to note holders sufficiently to render the protection of the securities laws unnecessary." *See Grotjohn,* 12 S.W.3d at 870.

In this case, none of those risk-reducing elements were present. As demonstrated below, there was and is no other regulatory scheme in Texas offering the same protections as the Texas Securities Act. The Texas Department of Insurance has never regulated transactions between viatical companies and investors. The Texas Deceptive Trade Practices-Consumer Protection Act imposes no regulatory requirements on the viatical industry such as registration and disclosure requirements and it contains weaker remedies than those provided under the Securities Act. *See* V.T.C.A., BUS. & C. CODE § 17.41 *et seq*. (Vernon 1987 & Supp. 2002). Nor was there any additional layer of insurance, such as an FDIC fund, that was applicable to these investments.

Finally, despite appearances to the contrary, investors did not benefit from any risk-reducing collateral. The security agreements accompanying the notes were meaningless. They granted investors a security interest in the death benefits expected in connection with their investments. But under this arrangement, the collateral was subject to exactly the same risk of dissipation or default that the underlying investment bore. For example, the amount that an investor would eventually receive under a note was subject to a host of variables, including promoter fraud, viator fraud, contestability issues, lapse,

and extended premium pay-outs. The collateral was essentially identical to the investment itself. It was therefore subject to the same risks and offered no additional layer of protection. Life Partners' portrayal of the security agreement as a safety net for investors was a sham. Under the *Reves* analysis, the notes sold to Griffitts were securities.

II. The "Insurance Contract" Exclusion From the Definition of a Security Does Not Apply to Life Partners' Viatical Settlement Contracts

The viatical settlement contracts that Life Partners sold to Griffitts do not fit within the plain terms or the underlying rationale of the insurance exclusion in the Texas Securities Act. The Act contains this provision removing certain insurance policies and related products from the definition of a security:

> [T]his definition shall not apply to any insurance policy, endowment policy, annuity contract, optional annuity contract, or any contract or agreement in relation to and in consequence of any such policy or contract, issued by an insurance company subject to the supervision or control of the Texas Department of Insurance when the form of such policy or contract has been duly filed with the Department as now or hereafter required by law.

TEX. REV. CIV. STAT. ANN. art. 581, § 4.

The intent and effect of this exclusion is to reach only insurance products – in the form of insurance policies or similar instruments – that have been issued by insurance companies and that are already subject to regulation by another administrative body, the Texas Department of Insurance. The contracts sold to Griffitts simply do not qualify for this exclusion because they were not issued by an insurance company, they are not insurance products, and they are not subject to regulation by the Texas Department of Insurance.

As a threshold matter, Life Partners is not an insurance company and does not claim to be one. This fact alone removes their contracts from the exclusion. With respect to the second failing, the viatical settlement contracts at issue are plainly not insurance products. Even the D.C. Circuit, which was willing to adopt a tortured interpretation of *Howey* to rule in favor of Life Partners, readily dismissed the notion that the Life Partners contract was in any way akin to insurance: "In short, a viatical settlement is not an insurance policy, and the business of selling fractional interests in insurance policies is no part of the 'business of insurance.'" *SEC v. Life Partners*, 87 F.3d at 540. Nor has any other state or federal court, with the sole exception of the lower court in this case, ruled or suggested that viatical settlement contracts should be excluded from the definition of a security on the theory that they are insurance products. *See Hill v. Dedicated Resources,* Case No. 99-C-1714 (Shawnee Co., Kans., Dist. Ct. 6, Jan. 3, 2001) (M.O. on Motion to Reconsider) (holding that defendant's being licensed by the Department of Insurance as a viatical representative/broker did not have a bearing on the Court's earlier decision that viatical settlements were securities, cited *supra*).

Finally, Life Partners' viatical settlement contracts are not regulated by the Texas Department of Insurance, and Life Partners itself is similarly unregulated by the Texas Department of Insurance with respect to the sale of viatical settlement contracts to investors. Applying the insurance exclusion to the Life Partners' contracts would therefore betray the rationale for the provision. A basic premise of the carve-out is that the excluded instrument be subject to meaningful regulation by another agency – the Department of Insurance – and that is not the case here. The Texas Insurance Code and

the regulations thereunder contain provisions relating to viatical settlements, but they were drafted solely for the protection of viators – the terminally ill whose life insurance policies are fractionalized. In both the code and the regulations, the goal of customer protection is carefully and expressly limited to *the persons who sell or otherwise transfer their life insurance policies*. *See* TEX. INS. CODE ANN. art. 3.50-6A, § 2(a) (Vernon 2002); Tex. Dep't. of Insurance, 28 TEX. ADMIN. CODE § 3.1701(a)(1) ("Reg.").

In fact, all of the Texas Insurance Code provisions and regulations relating to viaticals are aimed exclusively at the relationship between viatical promoters and viators, not between promoters and investors. For example, the regulations narrowly define "settlement contract" to mean only the transaction between the company and the viator. Reg. § 3.1702(24). Although viatical companies must file their forms with the Department, that requirement pertains only to those forms that are used in transactions with viators. Reg. § 3.1706. The sole reference in the code to "investor" appears in the admonition that "[t]he commissioner may not adopt rules that require the regulation of the actions of an investor providing funds to a viatical or life settlement company." TEX. INS. CODE ANN. art. 3.50-6A, § Sec. 2(f). The only regulation dealing with the assignment, sale, or transfer of policies requires that the viator be notified of such sale and that the viatical settlement company continue to track the viator's health thereafter. Reg. § 3.1713. The Texas insurance code simply was not intended to protect third-party purchasers of fractionalized interests in benefits under life insurance policies. *See* Albert, *supra,* 19 PACE L. REV. at 351.

Thus, the Texas Securities Act excludes only a narrowly defined group of insurance products where those products are regulated by the Texas Department of Insurance. Viatical settlement contracts entered into by investors are not insurance products and are not regulated by the Department of Insurance. It is therefore evident that the Texas legislature intended to leave the regulation of viatical investments in the hands of the Texas Securities Board. And this reflects the regulatory reality. The Texas Securities Board has consistently asserted its jurisdiction over the viatical investments offered by Life Partners and other viatical companies, and has brought numerous enforcement actions, both civil and criminal, against viatical providers for registration violations and fraudulent sales practices. By contrast, the Texas Department of Insurance has never brought an enforcement action against a viatical company for the protection of those who have invested in viatical settlement contracts.

III. Conclusion

It is essential that the regulatory framework under the Texas Securities Act remain applicable to viatical settlement contracts. Only in this way can the Court strike the right balance between protecting investors and serving the needs of the terminally ill. Griffitts is not seeking a ban against the sale of viatical settlement contracts. Rather, she is asking that these investments be properly recognized as securities under Texas law so that they are subject to registration and licensing requirements. These and other provisions of the Texas Securities Act provide investors with meaningful protections and remedies, including rescission for registration violations and damages for fraud. Such protections are especially important with respect to viatical contracts and other investment products

that are, by their nature, effective instruments of fraud. The Texas Department of Insurance does not and will not provide these safeguards to the citizens of Texas. If this Court rules in Griffitts' favor, as it should, the terminally ill and the elderly in need of funds will still have a market for their insurance policies, but not at the expense of important investor protections under the Texas securities law.

PRAYER

For the reasons expressed above, the *amicus curiae* prays that the Court reverse the decision of the district court and rule that viatical settlement contracts are securities under the Texas Securities Act.

Respectfully submitted,

Royce O. Griffin
Counsel for the Amicus Curiae

CERTIFICATE OF SERVICE

The undersigned certifies that a copy of the foregoing was served upon the following attorneys of record for all parties to the above cause by Certified Mail, Return Receipt Requested, in accordance with the applicable Rules of Procedure, on this the 15th day of February, 2002:

Attorneys for Appellant Griffitts

William B. Federman, Esq.
Stuart W. Emmons, Esq.
FEDERMAN & SHERWOOD
120 N. Robinson, Suite 2720
Oklahoma City, Oklahoma 73102

A. Daniel Woska, Esq.
WOSKA & HASBROOK, P.L.L.C.
120 N. Robinson, Suite 2720
Oklahoma City, Oklahoma 73102

David Matka, Esq.
Mark L. Nastri, Esq.
MUNSCH HARDT KOPF &HARR, P.C.
4000 Fountain Place
1445 Ross Avenue
Dallas, TX 75202-2790

Attorneys for Appellee Life Partners, Inc.

Vance Dunnam, Esq.
DUNNAM & DUNNAM, LLP
4125 West Waco Drive, P.O. Box 8418
Waco, TX 76714-8418

William D. Underwood, Esq.
1114 S. University Parks Drive
Waco, TX 76706

R. Michael Rogers, Esq.
1114 S. University Parks Drive
Waco, TX 76706

Jeffrey S. Levinger, Esq.
CARRINGTON COLEMAN SLOMAN & BLUMENTHAL, LLP
200 Crescent Court, Suite 1500
Dallas, TX 75201

Royce O. Griffin