XIII. Arnold v. Life Partners, Inc.: Life Settlements are Securities in Texas

A. Introduction

On August 28, 2013, the Dallas Court of Appeals held in Arnold v. Life Partners, Inc. that life settlements are securities subject to registration and regulation under the Texas Securities Act (“Act”).1 This determination will affect how regulators and courts regard companies that sell life settlements in the future.2 Prior to this decision, Texas was one of two states that had not decided whether life settlements were securities under state law.3 The Arnold court’s holding is consistent with the Security and Exchange Commission’s (“SEC”) recommendation to treat life settlements as securities.4 This decision follows a recent trend to adopt a more flexible, realistic approach in applying securities law, so that companies cannot easily circumvent regulation.5

This article analyzes the holding and impact of Arnold. Part B surveys Texas court decisions regarding life settlements, and Part C examines the impact of Arnold’s holding. Part D reviews the Arnold court’s analysis, and Part E discusses the present uncertainty among courts over the correct approach for applying securities law to life settlements.

B. Background

A life settlement, also known as a viatical settlement, is a contract in which an original owner (the “viator”) of a life insurance policy sells an interest in that policy to a third party investor for a

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3 Id.
sum of money. The investor acquires the life insurance policy at a discounted rate based on the insured’s life expectancy. The investor pays the premiums on the policy and receives the benefit of the policy upon the insured’s death. A life settlement’s profitability depends on the discount at which the investor purchased the policy and how long the insured lives after the sale. Some investors may be required to invest more money to cover additional premium payments if the insured outlives the anticipated life expectancy. Whether to define life settlements as investment contracts—which qualify as securities—has been the source of some debate.

In SEC v. W.J. Howey Co., the United States Supreme Court developed a test for what qualifies as an investment contract. The dispositive test for the Howey Court was “whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others.” Thus, the Supreme Court created a flexible standard for investment contracts, which aligned with congressional intent to broadly define what constitutes a security. The Howey test allows courts to extend securities laws to business practices that may not qualify as securities otherwise, but are nevertheless the kind of investments that Congress intended to regulate. The Howey Court stated that the test “embodies a flexible rather than a static principle, one that is capable

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6 Qaru et al., supra note 2.
7 Id.; see Arnold, 416 S.W.3d at 580.
8 Qaru et al., supra note 2.
9 Arnold, 416 S.W.3d at 580.
10 Id.
11 Compare Miriam R. Albert, The Future of Death Futures: Why Viatical Settlements Must Be Classified as Securities, 19 Pace L. Rev. 345, 349 (1999) (arguing that viatical settlements should be considered securities because lack of regulation leaves susceptible viators to gather information about the policies) [hereinafter Albert, Death Futures], with Shanah Glick, Are Viatical Settlements Securities Within the Regulatory Control of the Securities Act of 1933?, 60 U. Chi. L. Rev. 957, 975 (1993) (concluding that life settlements are unconditionally not securities).
13 Id.
15 See Albert, Howey Test, supra note 14, at 11–12.
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.” The test articulated in Howey is consistent with Congress’s goal of protecting investors through federal securities law.

The elements of the Howey test are: (1) “a person invests his money”; (2) “in a common enterprise”; and (3) “is led to expect profits produced solely by the efforts of [others].” Due to its flexibility, the fact-sensitive test has led to inconsistent results when applied by various state courts. Some elements are disputed more than others: much litigation involves the second part of the third prong—“solely from the efforts of others.” In fact, Texas courts have further divided the Howey test elements and treat “solely from the efforts as others” as a fourth factor.

Typically, a viator sells the right to a policy’s benefits when he or she is “terminally-ill.” The money from the sale often pays for expensive medical treatments and “provid[es] financial security” to the viator. Life settlements are thus motivated in part by the viator’s need for funds. Commentators in favor of classifying life settlements as securities assert that such classification would benefit “vulnerable” viators by encouraging investment in life settlements. These commentators are concerned that if life settlements are not classified as securities, investors would be “denied the protections and remedies provided by the federal securities laws,” and would have to “gather information themselves on which to base their investment decisions.” Life settlement investors may not continue to invest in life settlements if they are denied “necessary protections.”

Critics of this policy rationale argue that life settlements fail to satisfy the “solely from the efforts of others” prong of the Howey

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16 Id. at 13.
17 See id. at 11–12.
18 Howey, 328 U.S. at 299, 301.
19 See Albert, Howey Test, supra note 14, at 8.
20 See id. at 16–19.
23 Id.
24 See Albert, Death Futures, supra note 11, at 349.
25 Id. at 348–52.
26 Id. at 349.
27 Id. at 351–52.
test and are thus not investment contracts.28 These commentators
assert that one must be able to identify the “other” whose efforts
generate profits in order to satisfy the test.29 Neither the “policy
seller” nor the “viatical settlement broker” qualifies because their
efforts are “not post-sale managerial or entrepreneurial” and “end
before the actual event of assignment.”30

C. Different Approaches to the Fourth Factor

The fourth factor of the Howey test requires that the profits
from a common enterprise be “solely from the efforts of others.”31
Courts have contemplated different interpretations of “solely” in
applying the Howey test.32 Some courts interpret “solely” to mean
“only,” while others adopt a more relaxed interpretation meaning
“primarily,’ ‘substantially,’ or ‘predominantly’ from the efforts of
others.”33 Whether to apply a flexible, realistic analysis to the fourth
factor or to adopt a more rigid approach has led to inconsistent
decisions among the various courts, even when cases are factually
similar.34

1. The More Rigid Approach

In SEC v. Life Partners, Inc.,35 the D.C. Circuit held that life
settlements were not investment contracts because their profitability
relied on “the mortality of the insured,” instead of on “the post-
purchase managerial or entrepreneurial efforts” of the company.36
While the D.C. Circuit rejected Life Partners’ argument that its
settlements were insurance policies, it agreed with Life Partners that

28 Glick, supra note 11, at 972–73.
29 Id. at 972.
30 Id. at 972–75.
32 Albert, Howey Test, supra note 14, at 19.
33 Id.
34 See id. at 24 (explaining that the D.C. and Eleventh Circuits’ decisions
“both explicitly [avail] themselves of the flexibility that Congress created
by leaving the term investment contract undefined,” and since “the two
courts reached opposite conclusions . . . [but] the cases are factually
consistent . . . it is not possible to harmonize the two holdings”).
35 87 F.3d 536 (D.C. Cir. 1996)
36 Id. at 548; SEC v. Mutual Benefits Corp., 408 F.3d 737, 741 (11th Cir.
2005).
the “fractional interests” it sold to investors were not securities under
the 1933 Act. The court observed that the viatical settlements’
value arose from “the inexorable passage of time and the inevitable
death of the insured,” and distinguished between whether a
settlement company’s “activities” occurred before or after receiving
investor’s money. The court found that the “post-purchase
services” were not enough to satisfy the “solely by the efforts of
others” requirement of the Howey test.

2. The More Flexible, Realistic Approach

The facts in SEC v. Mutual Benefits Corp. were similar to
the facts in Life Partners, but the Eleventh Circuit adopted a more
flexible approach to the fourth factor of the Howey test. In Mutual
Benefits, the SEC sued a viatical settlement provider, alleging that
viatical settlements constituted securities under the “investment
contracts” analysis. In order to make a profit, investors depended
on the company’s expertise in properly determining life
expectancy. The Mutual Benefits court declined to adopt the
rationale articulated in SEC v. Life Partners, Inc., stating “[w]e are
not convinced that . . . Howey . . . requir[es] such a clean distinction
between a promoter’s activities prior to his having use of an
investor’s money and his activities thereafter.” The court stated that
the company’s activities before the investment should not be
excluded from the analysis since investment schemes often involve
activities both before and after the investors’ purchase. The court
also noted that the profitability of the investment depended on
experts’ choices rather than “market speculation.” The Mutual
Benefits court urged that “form should be disregarded for substance
and emphasized “economic reality” when defining investments as
securities. Accordingly, the court found that the fourth factor of the

37 Life Partners, 87 F.3d at 549.
38 Id. at 543.
39 Mutual Benefits, 408 F.3d at 743.
40 Life Partners, 87 F.3d at 549.
41 Mutual Benefits, 408 F.3d at 743–45.
42 Id. at 738–41.
43 Id. at 739.
44 Id. at 743.
45 Id. at 743–44.
46 Id. at 744.
47 Id. at 743 (citing Tcherepnin v. Knight, 389 U.S. 332, 336 (1967)).
Howey test was satisfied and that viatical settlements were securities.48

D. Texas Decisions on Life Settlements as Securities

The Texas Supreme Court first adopted the Howey test in Searsy v. Commercial Trading Corp., and divided it into four factors: "(1) an investment of money; (2) in a common enterprise; (3) with an expectation of profit; (4) solely from the efforts of others."49 The Arnold court focused on the “solely from the efforts of others” language after concluding that there was no dispute as to the other factors.50 Commentators noted that the Arnold court followed the Searsy court’s recommendation to apply the fourth factor “realistically,” rather than “rigidly or literally.”51

In Arnold, Life Partners, a financial services company, purchased life settlement accounts at a discount and located investors who wished to acquire a “fractional interest” in the policies.52 Life Partners paid viators a cash settlement in exchange for changing policy ownership to the company.53 The investors deposited money into a trust account owned by Life Partners and paid any additional premium payments necessary to maintain a policy if a viator lived longer than originally estimated.54 The Arnold court stated that “[t]he most critical element determining whether an investor will make a profit on the life settlement transaction is the ‘discount’ at which Life Partners acquires a life insurance policy from a viator.”55 The investors never owned the policies directly and were not the named beneficiaries, nor did they know the amounts of the cash settlements Life Partners paid to the viators.56 The Arnold court observed that Life Partners “holds the policies as ‘agents’ for the investors.”57

The plaintiffs—Life Partners’ investors—alleged that Life Partners had not complied with the Texas Securities Act, and that, as

48 Id. at 744–45.
50 Carroll, supra note 5.
51 Id.
53 See id.
54 Id.
55 Id.
56 Id.
57 Id.
a result, they were entitled to “rescission or damages.” The Texas Securities Act defines securities as:

any share, stock, . . . note, bond, debenture, mortgage certificate or other evidence of indebtedness . . . or any certificate or instrument representing or secured by an interest in any or all of the capital, property, assets, profits or earnings of any company, investment contract, or any other instrument commonly known as a security, whether similar to those herein referred to or not.

The investors alleged that Life Partners had told them that the life settlements did not qualify as securities. The investors argued, however, that the life settlements were securities under the investment contract definition, and not insurance policies, which would be exempted from the Act.

1. The Old Approach: Griffitts v. Life Partners, Inc.

In a previous Texas case against the same company, the Dallas Court of Appeals adopted a rigid approach to the Howey test, holding that life settlements were not securities. In Griffitts v. Life Partners, Inc., an individual who purchased interests in life insurance policies brought a suit for rescission on the grounds that the offer of the policies violated the Texas Securities Act. The Griffitts court focused on the “common enterprise” factor of the Howey test. The court stated that an enterprise does not exist where “a promoter merely holds an investment in anticipation of appreciation or maturity.” Moreover, the court reasoned that a promoter may engage in “managerial efforts,” as long as they do not

58 Id.
59 TEX. REV. CIV. STAT. art. 581-4(A) (West 2013).
60 Arnold, 416 S.W.3d at 580.
61 Id. at 580–81..
63 Id. at *1.
64 Id. at *2.
65 Id.
determine the profits of the company. The court stated that Life Partner’s managerial efforts did not have an effect on the profitability of the policies since the profitability was based on the insured’s life span. Further, the court noted that Life Partners had “no common interest” in the profits, which “came solely from Life Partners’ efforts.” Therefore, the court held that a common enterprise did not exist, and the insurance policies were not investment contracts.

2. The Arnold Court’s Approach

The Arnold court found no merit in Life Partners’ argument that its life settlements were insurance policies, which fall under an exclusion of the Texas Securities Act. Recognizing that it was only obligated to follow higher Texas courts and the United States Supreme Court, the court declined to follow Griffitts v. Life Partners, Inc., since it was non-binding precedent. The court acknowledged that Griffitts placed a lot of emphasis on the D.C. Circuit’s approach in SEC v. Life Partners, Inc. Faced with a new opportunity to rule on the issue of life settlements, the Arnold court, like many other lower state courts, focused on the “remedial goals of their state securities law and the persuasive, non-binding nature of federal court decisions on state courts interpreting state laws.”

The Arnold court followed the Eleventh Circuit’s approach and found that the efforts of Life Partners were “undeniably significant . . . [in] the failure or success of the enterprise.” The court also noted that early cases had given “literal effect” to the “solely from the efforts of others” language but that the “recent trend” was to apply the requirement flexibly. The court was concerned that a company’s activities could easily circumvent

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66 Id.
67 Id.
68 Id.
69 Id.
70 See TEX. REV. CIV. STAT. art. 581-5(C)(2) (West 2013); Carroll, supra note 5.
71 Carroll, supra note 5.
73 Albert, Howey Test, supra note 14, at 33 n.161.
74 Id. at 33–34.
75 Carroll, supra note 5.
76 Arnold, 416 S.W.3d at 583.
securities regulation if the fourth requirement were not interpreted broadly.\footnote{Id.} Accordingly, the \textit{Arnold} court focused on Life Partners’ involvement prior to the death of the insured, and declined to view date of death as the only relevant factor in determining the success of the investment.\footnote{Id. at 588.} The court specifically noted the language of a document given to investors, which stated: “[Y]ou will be dependent upon LPI to track insureds’ health status and whereabouts.”\footnote{Id. at 587.} This, along with other language, indicated that the investors’ relied on Life Partners’ expertise in order to profit.\footnote{Id.} Finding the fourth factor satisfied, the court held that life settlements are securities that fall under the Texas Securities Act.\footnote{Id. at 589.}

3. Impact of \textit{Arnold}’s Holding

After \textit{Griffits}, but prior to \textit{Arnold}, the Texas Securities Board evaluated whether a life settlement qualified as a security on a case-by-case basis.\footnote{LIFE SETTLEMENTS TASK FORCE, STAFF REPORT TO THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION 36 n.175 (July 22, 2010), https://sec.gov/news/studies/2010/lifesettlements-report.pdf.} After \textit{Arnold}, however, Life Partners and other companies that sell life settlement interests in Texas will now be subject to registration and regulation under the Texas Securities Act.\footnote{See Carroll, supra note 5.} This decision aligns with the SEC’s position on life settlements.\footnote{Qaru et al., supra note 2.} In 2010, the SEC released a staff report “recommending that life settlements be clearly defined as securities so that the investors in these transactions are protected under the federal securities law.”\footnote{Press Release, SEC, supra note 4.} The report noted that almost all states treat life settlements as securities under state securities law, either by defining life settlements as securities explicitly or by finding them to be securities under the investment contract analysis.\footnote{LIFE SETTLEMENTS TASK FORCE, supra note 82, at 36.
E. Uncertainty and Inconsistency

The Arnold court followed a “trend of recent decisions” in the Eleventh Circuit and in Arizona, Colorado, Indiana, and Georgia state appellate courts, which apply a more flexible approach to the fourth requirement of the Howey test. The Supreme Court, however, has remained silent about these lower court interpretations. Encouraging a liberal construction of the fourth factor appears consistent with legislative intent and allows for stronger investor protection. Moreover, applying a rigid approach to the fourth requirement of the Howey test could give companies a means to avoid securities regulation, even if such regulation could help protect investors. Since interpretation and application of the Howey test has not been uniform, investors face different levels of protection in different jurisdictions when purchasing similar products. The Supreme Court could overcome this uncertainty by revisiting the Howey test and providing a definitive approach to its factors.

F. Conclusion

The Arnold court’s decision that life settlements are securities and subject to registration and regulation under state securities law is consistent with the SEC’s recommendation and allows for more investor protection. Texas joined other states that regard life settlements as securities by adopting a more flexible, realistic approach to the “solely from the efforts of others” factor. Varying approaches to this language in the Howey test have led to inconsistent results on similar fact patterns. However, the flexible,

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87 Carroll, supra note 5.
88 See Albert, Howey Test, supra note 14, at 31–32.
89 See id. at 7–8.
90 See id. at 37.
91 See id.
92 Id. at 38.
93 See Albert, Howey Test, supra note 14, at 7–8; Press Release, SEC, supra note 4.
94 See Carroll, supra note 5.
95 See Albert, Howey Test, supra note 14, at 8 (“The intentional breadth and adaptability of the definition of investment contract necessarily leads to complex and fact-intensive judicial inquiries in the application thereof, and allows for the possibility of inconsistent results between and among the
more realistic approach is more in line with the goal of Congress to allow more investor protection.\textsuperscript{96} Texas’s classification of life settlements as securities under the flexible approach is thus a good decision, at least until the Supreme Court gives more definitive guidance on how to interpret the \textit{Howey} test.

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