Testimony of Lee Covington
Director of Insurance
State of Ohio

Before the
Subcommittee on Oversight and Investigations
Committee on Financial Services
U.S. House of Representatives

Regarding
Viatical Fraud and
The Financial Services Antifraud Network Act of 2001

February 26, 2002

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Madam Chair and Members of the Committee –

My name is Lee Covington and I am the Director of the Ohio Department of Insurance. Thank you for the opportunity to be here today to address the problem of viatical fraud and the steps I have taken to combat this type of insurance fraud. I commend the Chair and the committee for its interest in this important issue. I also want to thank this committee and the House of Representatives for its favorable action on Chairman Oxley's H.R. 1408, Financial Services Antifraud Network Act of 2001, and discuss with you how this legislation will enhance the ability of states to currently identify and fight all types of insurance fraud.

During today's testimony, I will discuss:

1. How viatical and life settlement transactions operate and how these transactions can help some of our most vulnerable citizens—terminally ill individuals and senior citizens.

2. The insidious nature of viatical fraud, including how a fraudulent scheme is perpetrated;

3. The steps taken in Ohio and across the country to combat this type of fraud through vigorous criminal investigation and prosecution;

4. Legislative action taken in Ohio and across the country to eliminate or significantly reduce this type of fraud; and

5. The critical need for the Senate to pass Chairman Oxley's H.R. 1408 to provide the states and the federal government the additional tools necessary to fight all types of insurance fraud.

Viatical and Life Settlement Transactions—The Sale of Life Insurance Policies by Terminally Ill Individuals and Senior Citizens

Viatical and life settlement transactions enable terminally ill individuals and senior citizens with a limited expected life span to receive a portion of their life insurance benefits prior to death. The word "viatical" is derived from the Latin word "viaticum," which described the payment or provisions given to Roman soldiers before going to war. In a viatical settlement, a viator, who most often is a terminally ill person, or as we are now seeing, a healthy senior citizen, receives a portion of the face value of a life insurance policy in a lump sum prior to death. In this transaction, the viatical settlement provider pays the viator a discounted amount for the life insurance policy, and the viator transfers ownership of the life insurance policy to the viatical settlement provider or related entity, who becomes the named beneficiary under the policy. After the sale between the viator and viatical settlement provider, the viatical settlement provider sells the life insurance policy to investors who provide the funds that the viatical settlement provider pays to the viator. The transfer of funds is conducted through an escrow agent who will provide the documents to the provider and, as soon as the ownership of the policy changes, the escrow agent will send the money to the viator. In most cases, ownership of the life insurance policy or security is held by a business entity that, in turn, will sell interest in the policy to the investors. In sum, the terminally ill person or senior citizen is paid a reduced amount in exchange for the selling of the policy and the viatical settlement provider then has the right to recover the full amount of the life policy upon the viator's death.

While the nature of viatical transactions is dependent on the death of the viator, the social benefit of viaticals are extremely valuable for some terminally ill persons and senior citizens. The money obtained through the sale of viated insurance policies can be used for anything -- from experimental medical treatments not covered by insurance to paying off accumulated bills. Therefore, the social benefit may be very important for some of these individuals. Unfortunately, fraud jeopardizes the very existence of this industry.

Ohio Viatical Fraud Investigation—Largest in History

State and federal regulators and prosecutors know that fraud can occur in the procurement and transfer of the ownership of life insurance policies and that has been verified by our recent investigation of an Ohio viatical company. According to a Florida grand jury investigation, as many as half of all life insurance polices involved in viatical transactions may have been obtained with fraudulent intent.

In the largest insurance fraud investigation ever undertaken in the history of the Ohio Department of Insurance, we uncovered a scheme that defrauded victims of more than $100 million. Our investigation, which was a joint effort of the Ohio Department of Insurance and several federal agencies, resulted in the indictment of 15 individuals who fraudulently obtained multiple life insurance policies and an indictment of the owner of Liberte Capital Group, a Toledo-area viatical settlement company. Before providing the details of this investigation, I want to give special recognition to United States Attorney, Emily Sweeney and Assistant United States Attorney, Seth D. Uram, the Federal Bureau of Investigation, the Internal Revenue Service, and the United States Postal Inspection Service, and several other states' insurance departments for their work and partnership in this effort.

The Ohio Department of Insurance opened its investigation in the summer of 1999 after receiving a tip from an insurance company. When our investigators began looking into this case, we discovered that the alleged fraudulent activity was occurring in several states. Because of the multi-jurisdictional nature of the investigation, we contacted the federal agencies and we combined our resources to investigate the case. The combination of state and federal resources has enabled us to identify, investigate and indict individuals who conspired to defraud nearly 3,000 investors of more than $100 million.

The Department of Insurance investigation focused on 32 viators who are accused of fraudulently obtaining at least five (5) life insurance policies each and collectively obtaining approximately 200 policies and selling them to Liberte Capital Group. Viators fraudulently obtain insurance policies by:

- <u>Cleansheeting</u> – The fraud occurs when applicants lie on an application about their bad health condition in order to purchase a life insurance policy. Insurers generally will not issue a life insurance policy to someone with a terminal illness.
- <u>Imposter Fraud</u> – An individual will pose as another person who is applying for an insurance policy. The imposter may take blood tests and/or physicals for the insured, which often misleads an insurance company into believing the applicant is in good health.

Because of this investigation, 85 insurance companies were able to rescind most of the fraudulent policies, saving the companies more than $25 million. This type of fraud against insurance companies and investors can severely damage the financial solvency of an insurance company and wipe out all the assets of an investor. The victims of this fraud are not just insurance companies and their legitimate customers who end up paying more in higher premiums, but also consumers who stand to lose their investment when policies are cancelled or lapse.

Viatical fraud is complex and it is challenging to uncover this type of fraud. Ohio Department of Insurance fraud investigators discovered and reviewed three storage rooms full of evidence, conducted hundreds of interviews, and organized thousands of documents that were presented to the grand jury that handed up the indictments. The Department investigator assigned to this case devoted more than 4,000 hours to the effort during the past three years.

Ohio Anti-Fraud Legislation

In addition to our aggressive anti-fraud criminal investigation efforts, the Ohio Department of Insurance has been active on the legislative front as well, developing and working on a new law, sponsored by state Representative Amy Salerno (R-Columbus), to prevent this kind of fraud. In January of 2001, Governor Bob Taft signed into law legislation providing for the specific licensing and increased regulation of viatical settlement providers and brokers. This legislation was strongly supported by the Ohio Department of Insurance and the Ohio Department of Commerce. House Bill 551 was based on a model developed and adopted by the National Association of Insurance Commissioners in March 2001, and I am proud to report that Ohio was the first state to adopt this model.

The new law:

- Includes a clear definition of fraudulent viatical settlement acts and provides administrative and criminal penalties for violations which gives the Department the authority to request an injunction ordering a viatical settlement provider, broker or person to immediately stop potentially harmful activities during an investigation, which can prevent or limit the scope of damages and the number of victims.

- Prohibits brokers and providers from entering a viatical settlement contract within two (2) years of issuing a life insurance policy unless they meet one of these four (4) legitimate exceptions:
    - The viator or insured is terminally or chronically ill;
    - The viator's spouse dies
    - The viator divorces their spouse;
    - The viator becomes physically or mentally disabled and a physician determines that the disability prevents the viator from maintaining full-time employment.

  This keeps viators from fraudulently obtaining and immediately viatizing insurance policies – what are known in the industry as "wet viaticals," because viators complete the fraudulent viatical transaction before the ink is even dry from their signing of the fraudulent application.

- Requires a notice be sent to the insurer within 20 days of an agreement to viaticate a policy. This alerts an insurance company that they may want to examine the policy for potential fraud. If the insurer can prove the policy was obtained fraudulently, it can rescind the policy.

- Requires viatical settlement providers and brokers to obtain a license from the Department of Insurance in order to engage in the sale of viatical settlements. This law subjects brokers and providers to the oversight and regulation of the Department. Previously, there was no oversight or regulation of this industry in Ohio.

- Clarifies that viatical settlement transactions are "securities" under Ohio law and subject to all regulation associated with securities.

This law gives the Department of Insurance and the Ohio Department of Commerce the ability to protect Ohio consumers.

The new law enables us to aggressively combat viatical fraud. Without the work of the state and federal agencies involved in this investigation, many more investors and companies could have been hurt by this scheme. I am confident that the actions of law enforcement agencies involved in this case will serve as a deterrent to this type of crime in the future. I also believe that the viatical anti-fraud laws adopted last year in the state of Ohio will aid these agencies in the regulation of the viatical industry.

Actions by Other States

Although I have focused on Ohio's activities and accomplishments, I know this issue is a high priority for other states. This industry is rapidly evolving, and constant monitoring of the changes in the industry has been a priority for the states.

At least 12 other states have or have pending regulations to update their laws by adopting the NAIC model, which was finalized in March 2001. A majority of the states (29) have similar laws and are expected to determine if they need to revise their current laws to provide additional protections against viatical fraud.

In terms of protecting consumers, state insurance regulators have been responsive to the need to regulate the viatical industry and provide a safety net to ensure that viatical fraud is detected and eliminated. Key components of these state laws are licensure, disclosure, and notice of these transactions. The majority of states have these requirements for those individuals that engage in viatical settlement transactions.

The NAIC acted previously to protect the terminally ill through Model Laws adopted in 1993 and 1998. These models focused on consumer protections aimed at ensuring that the terminally ill were provided disclosures regarding alternatives to viatical settlements, tax implications, and other important consumer rights. Unfortunately, until 1999, no one ever anticipated these transactions would be adulterated by the acts of criminals ready to perpetrate fraud.

Based on the information I have received, it appears that the insurance industry first became aware of this type of fraud at some point in 1999. Based on our research, John Hancock Life Insurance Company was the first insurance company to take action to rescind fraudulently obtained policies when it filed a court action in Florida in late 1999. Therefore, in a little over a year after the very first actions on this type of fraud, the NAIC updated and adopted a Model to address this type of viatical fraud.

Need for H.R. 1408, Financial Services Antifraud Network Bill

Congress can help state regulators in our efforts to combat insurance fraud, and the House of Representatives has already done so by passing Chairman Mike Oxley's legislation, H.R. 1408, Financial Services Antifraud Network Act of 2001. This bill is a giant step forward, and I strongly support immediate action by the United States Senate to pass this legislation.

This legislation will be extremely beneficial to state regulators because it provides state regulators access to an existing network of criminal and administrative databases, including the Federal Bureau of Investigation's antifraud database. According to the Coalition Against Insurance Fraud, insurance fraud costs American families almost $1,000 per year. It is tax imposed on each American by criminals.

While much of our success in the recent viatical fraud investigation was attributable to our close working relationship with federal agencies, Chairman Oxley's bill will formalize these interactions and encourage comprehensive cross-regulatory coordination to detect fraud and provide comprehensive guidelines for safeguards to protect the confidentiality, privacy, and security of shared information.

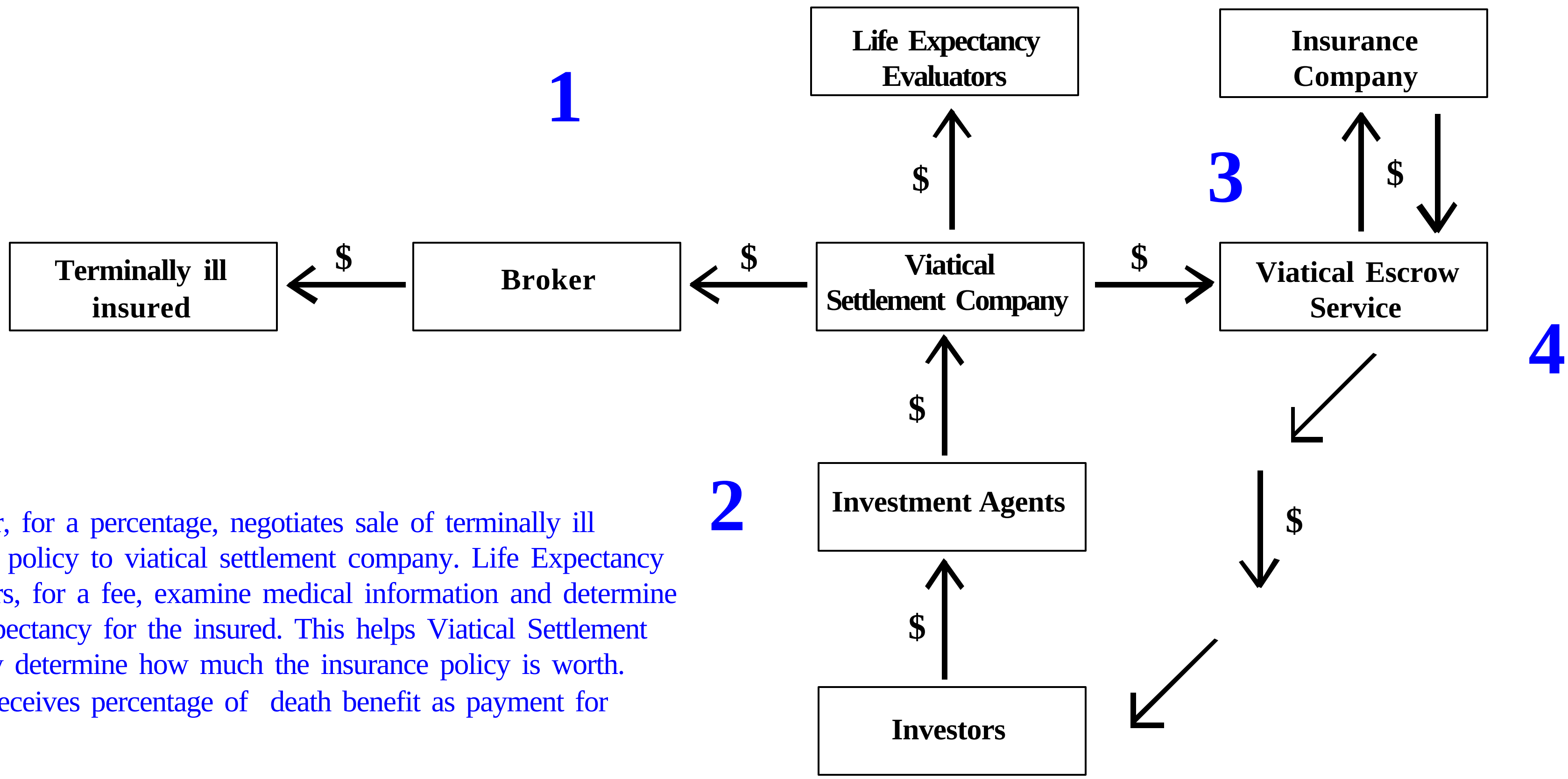
Ohio has also taken steps to ensure the clarity of our statutory authority to share non-public records regarding fraud investigations. Senate Bill 138, our information sharing legislation, was part of the NAIC's effort to ensure that all states have the ability to enter into and participate in information sharing agreements among state and federal functional regulators and law enforcement agencies.

Conclusion

In conclusion, Ohio and other states have put the viatical industry on notice – if they are going to do business in our states, they must comply with all our requirements or we will take aggressive action. I am pleased that our investigation was successful and know that on-going efforts to eliminate this fraud will yield positive results. We recognize this industry is changing quickly. State regulators are on the front lines of ensuring that existing laws are sufficient and that regulators can quickly respond to address any new developments that may emerge.

I again appreciate this opportunity to testify before the committee on viatical fraud. I thank you for your effort to combat fraud across all financial services industries, and I urge the Senate to act quickly to pass H.R. 1408, to provide regulators additional tools to fight fraud. I would be happy to answer any questions.

How a Viatical Settlement Agreement is supposed to work



1. Broker, for a percentage, negotiates sale of terminally ill insured's policy to viatical settlement company. Life Expectancy Evaluators, for a fee, examine medical information and determine a life expectancy for the insured. This helps Viatical Settlement Company determine how much the insurance policy is worth. Insured receives percentage of death benefit as payment for policy.

2. Settlement company investment agents sell policies to investors for a percentage. They use marketing materials provided by Viatical Settlement Company.

3. Viatical escrow service holds investor money and pays premiums to insurance company.

4. When insured dies, insurance company pays death benefit to viatical escrow services who pays the investors.

Where Viatical Fraud Occurs

Follow the Money ($100,000 policy)

Life Expectancy Evaluators receives fee of $250 for reviewing medical files and settling life expectancy.

Insurance Company receives premium payments and pays $100,000 death benefit

1

Terminally ill insured recieves $10,000 for cleansheeted $100,000 policy

$

2

Broker receives $5,000 for negotiating deal for fraudulent policy

$

3

Viatical Settlement Company knowingly purchases and markets fraudulent policies and receives $20,000

$

Viatical Escrow Service embezzled from escrow accounts money that should have been used to pay premiums and payoff investors. 5

$

4

Investment Agents receive 6 percent ($600) of investment for finding investors

$

Investors pay $36,000

1. Insured cleansheets policy or several policies by lying on their applications in order to purchase a policy.

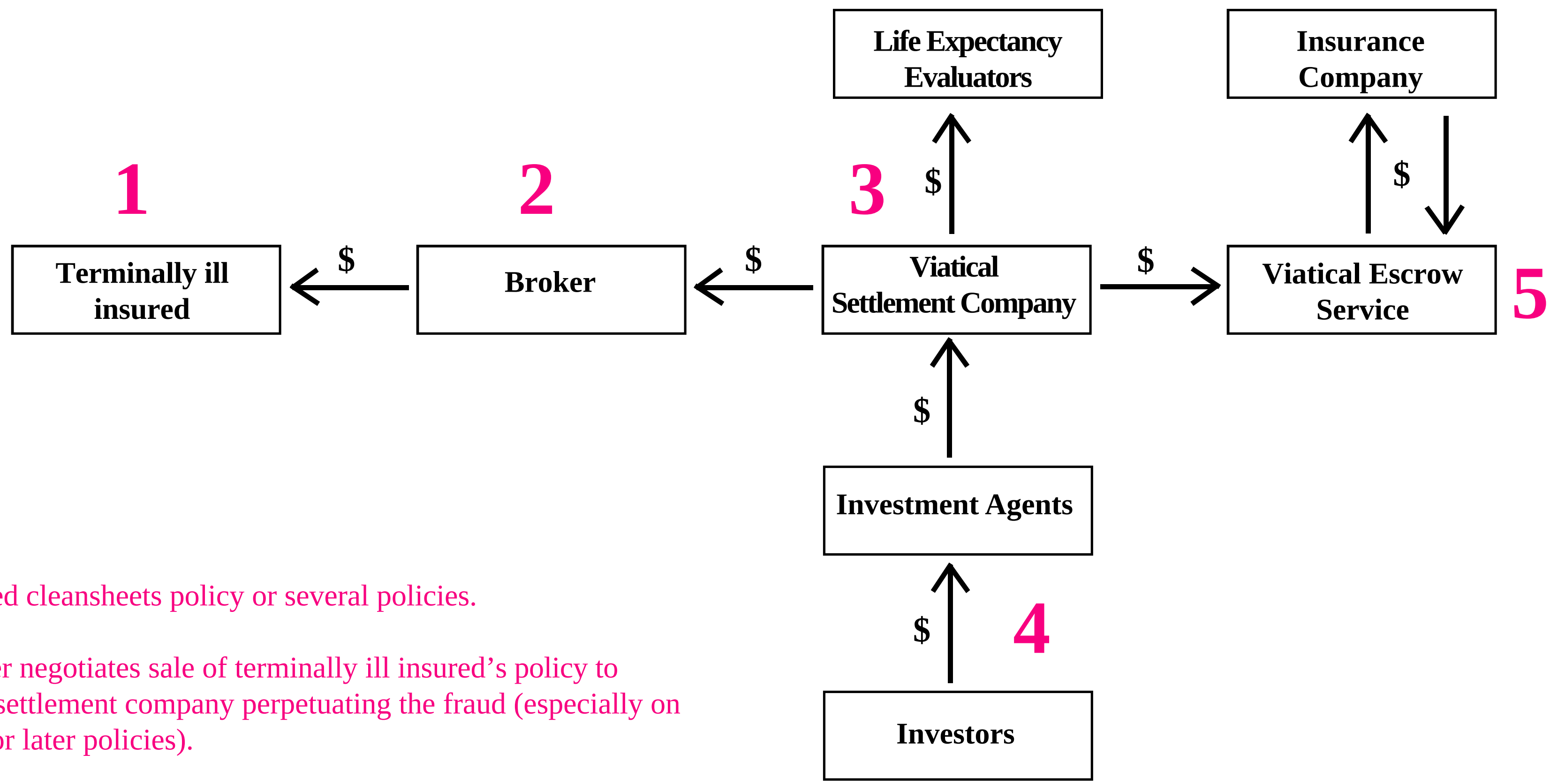
2. Broker negotiates sale of terminally ill insured's policy to viatical settlement company perpetuating the fraud especially on second or later policies because they have knowledge of the fraudulent policies.

3. Settlement Company knowingly purchases fraudulent policies from insured and markets policy through investment agents.

4. Marketing materials often misrepresent risk and falsely claim that Guaranty Funds back up the investment.

5. Viatical escrow service embezzles money from escrow accounts. When insured dies, viatical escrow service has no money to pay investors.

Where Viatical Fraud Occurs



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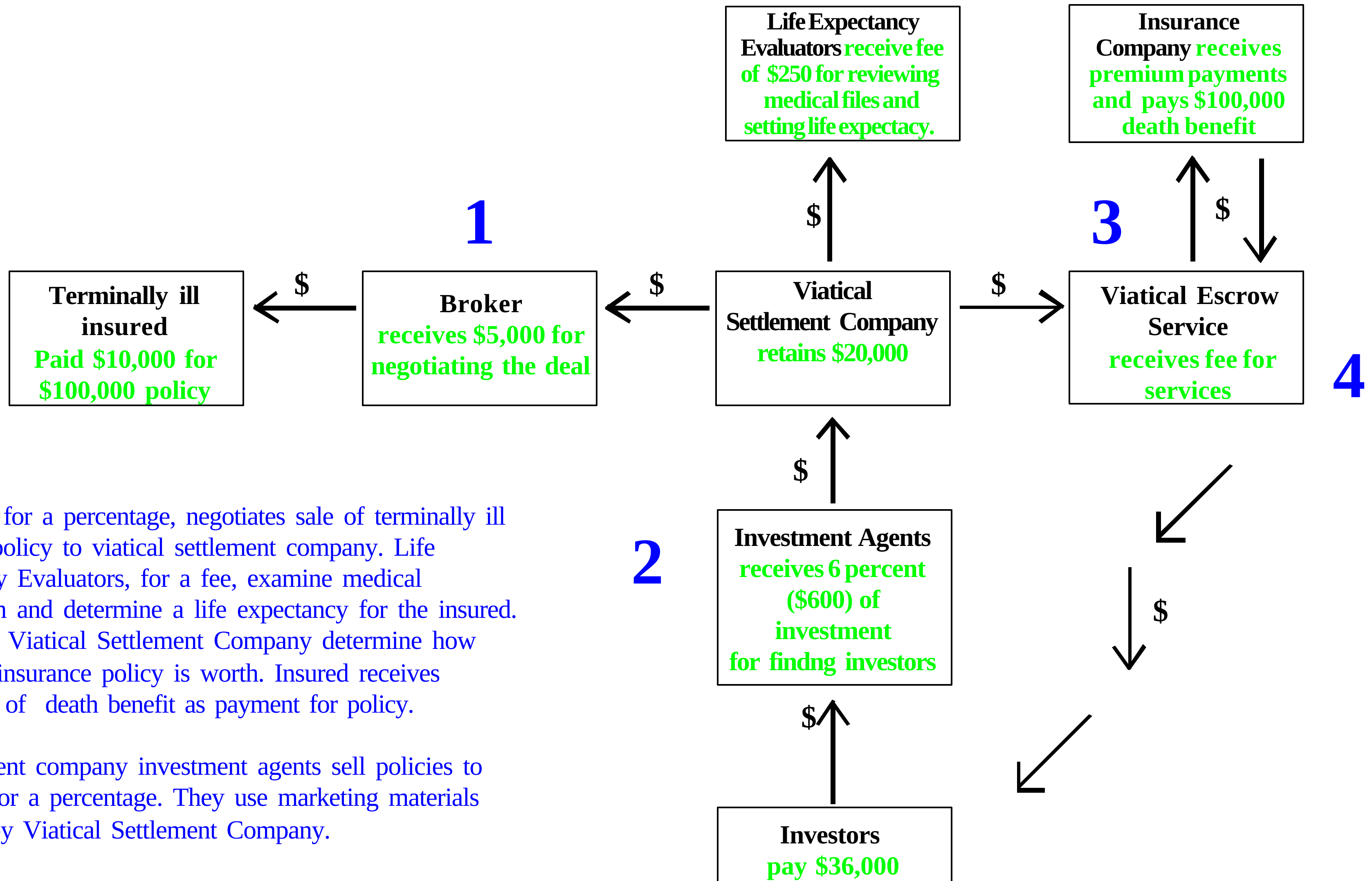

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Investor money goes to pay premiums, broker's percentage, escrow services, life expectancy evaluation, and terminally ill insured.