State of Washington
Department of Financial Institutions
Securities Division

IN THE MATTER OF DETERMINING Whether there has been a violation of the Securities Act of the State of Washington by: RICHARD J. FOSTER; MG INSURANCE SERVICES; VIATICAL CAPITAL, INC; VIATICAL MARKETING, INC.; VIATICAL FUNDING LLC-III; AND VIATICAL FUNDING LLC-GI-V; Respondents	SDO-01-98 ENTRY OF FINDINGS OF FACT AND CONCLUSIONS OF LAW AND FINAL ORDER TO CEASE AND DESIST Case No.: No. 98-02-64

THE STATE OF WASHINGTON TO: Viatical Capital, Inc; Viatical Marketing, Inc.; Viatical Funding LLC-III; and Viatical Funding LLC-GI-V.

INTRODUCTION

The purpose of this proceeding is to determine whether the State of Washington, Department of Financial Institutions, Securities Division ("State" or "Department") should be allowed to enter an order to cease and desist against respondents herein.

On January 5, 1999, the department entered a statement of charges and notice of intention to enter an order to cease and desist which charged the respondents Richard J Foster, MG Insurance Services, Viatical Capital, Inc., Viatical Marketing, Inc., Viatical Funding LLC-III and Viatical Funding LLC-GI-V with 1) offering unregistered securities in the form of investments in limited liability company interests; 2) acting as unregistered broker-dealers and sales persons in securities; and 3) violating the anti-fraud provisions of the Securities Act of Washington, chapter 21.20 RCW. This statement of charges was captioned SDO 105-98, but was entered in the Department's order book as SDO 99-13.

Richard Foster and MG Insurance Services, who were named in the Department's statement of charges, did not timely request a hearing and a final order to cease and desist (SDO 99-32) was issued to each of them on May 11, 1999.

PROCEEDINGS

Respondents VCI, VMI, LLC-III and LLC-GI-V timely requested a hearing. The hearing was conducted by the Todd Gay, administrative law judge, under the authority of the administrative procedure act, chapter 34.05 RCW; and chapter 34.12 RCW, which governs the office of administrative hearings. The Respondents were represented by John Hough, Esq. and Lane Powell Spears Lubersky. Alice Blado, Assistant Attorney General, represented the Department.

On December 11, 2000, Respondents' motion for partial summary judgment was denied on the record. Testimony was taken at hearing held December 11 through 15, 2000 in Vancouver and Olympia.

On May 29, 2001, Judge Gay entered his findings of fact, conclusions of law, and initial order (Initial Order) in which he ordered Respondents to cease and desist from violations of the Securities Act.

On June 28, 2001, the Department filed a Petition for Review of the Initial Order pursuant to RCW 34.05.464.

On July 16, 2001, the Director of the Department, John L. Bley, appointed William M. Beatty as Reviewing Officer to assist in the review of the Initial Order and preparation of a final order. Based on that review, the Director makes the following findings of fact and conclusions of law:

FINDINGS OF FACT

1. Viatical Capital, Inc. (VCI) and Viatical Marketing, Inc. (VMI) organized a series of limited liability companies (LLCs) under Nevada law for the purpose of pooling investors' money to purchase life insurance policies at discounts from terminally ill policyholders. These discount purchases are called viatical settlements.

2. Douglas York and Robert Coyne own VCI, VMI and other affiliated entities. VCI and VMI marketed LLCs under the name of Viatical Funding LLC. Investors in the several LLCs received a brochure. S. Ex.1.

3. In 1997, VCI and VMI formed Viatical Funding LLC-III and Viatical Funding LLC-GI-V, and other Nevada LLCs after soliciting investors from around the country, including Washington State. Respondents' objective was to accumulate approximately $1 million in each LLC before committing it to investing in viatical settlements.

4. Respondents recruited sales agents primarily through the insurance sales industry. Many of the agents are licensed insurance agents. These agents solicited prospective investors by calling on their insurance clients, or by mailings. Respondents offered sales agents commissions, up to eight percent of investor funds received. Respondents provided agents sales materials in the form of brochures and videos. Some sales training was conducted by telephone.

5. Respondents, through their agents, sold the LLC investments to Washington residents, primarily senior citizens, including Viatical Funding LLC-III and Viatical Funding LLC-GI-V.

6. Respondents provided prospective investors with a glossy brochure entitled "Viatical Funding LLC" (S. Ex. 1) and sometimes either provided or showed investors sample documents called the "Membership Application" and "Operating Agreement." S. Ex. 7 and 8.

7. Prospective investors were required to fill out a questionnaire and provide personal information on their income, net worth, and investing or business experience.

8. Usually VCI sales agents orally discussed with prospective investors the requirement that investors must "actively manage" the investment. VCI sales agents failed to advise at least two prospective investors who invested in LLC-III and LLC-GI-V that members were expected/obligated to manage the investment. Investors could meet the obligations by attending meetings in person or by conference telephone calls, or by voting by proxy by mail. VCI provided investors proxies for the organizational meeting in which the investors could appoint VCI or another person to represent them at the meeting. Investors could choose to serve on the "Executive Committee" of an LLC for the

purpose of managing the LLC. None of the Washington investors served on the "Executive Committees" of LLC-III, LLC-GI-V or any other LLC for purposes of managing an LLC. Washington investors in LLC-III, LLC-GI-V and other LLCs were not informed of the identity of the executive committee members and were not advised of the identity of fellow investors until as much as two years after they made their initial investment.

9. VCI required investors to sign a statement that they understood the active management requirement and that they understood that the investment was not a registered security and was not subject to securities laws.

10. VCI organized the LLCs, organized the meetings, provided investors with a slate of professional service providers, recommended viatical settlement companies as sources of policies, negotiated and purchased policies on behalf of investors in the pre-organizational stages of the LLCs, and after the LLCs were formed, processed tax information, prepared monthly statements of account balances for investors, sent out newsletters, responded to investor questions, and provided administrative services to the LLCs.

11. In return for its organizational and other efforts, VCI received compensation in the form of placement fees (eight percent of the funds raised) and administration fees (up to five percent of the funds raised). VCI also received a non-voting equity interest of ten percent of each LLC, which entitled it to receive a proportion of each LLC's distribution of capital, dividends, profits and assets.

12. The testimonial evidence shows that some of the LLC investors, including investors in LLC-III and LLC-GI-V, did not have the desire or inclination to manage a business; had no experience in managing a business of any kind; had no understanding of the exact nature of the viatical settlement business except for the fact that the companies in which they invested would be purchasing life insurance policies; were not financially sophisticated and did not appear to possess investing experience, education or background to evaluate the merits and risks of the investment; were of modest financial means and did not appear as sophisticated investors on the basis of net worth and income; due to age

and health, found it difficult or impossible to actively participate in the management of the business; and necessarily relied on the efforts of others, including and especially VCI, to provide the essential managerial expertise necessary for the success of the venture.

13. Respondents failed to disclose to LLC-III and LLC-GI-V and other LLC investors all the material facts of the investment, such as risks of the offering, sales commissions, business history, and financial condition of the Respondents.

14. Respondents did not register with the department under Washington securities law the offer and sale of the LLCs as securities. Nor did Respondents or their agents register as securities broker-dealers or salespersons.

CONCLUSIONS OF LAW

A. LLC Investments as "Securities" under the Investment Contract Test.

1. At issue is whether these LLC investments should be considered securities under Securities Act of Washington, chapter 21.20 RCW. The parties are in agreement the question may be narrowed to whether the investments are securities as defined under RCW 21.20.005(12) which includes, inter alia, the term "investment contract" the definition of which has been developed in case law since the U.S. Supreme Court enunciated elements in *S.E.C. v. W.J. Howey Co.*, 328 U.S. 293 (1946).

2. The definition of a security embodies a flexible rather than a static principle that is capable of adaptation to meet the countless and variable schemes devised by those who seek to use the money of others on the promise of profits. *State v. Argo*, 81 Wn.App. 552 (1996)(citing *Howey*). The Washington State Supreme Court has recognized that "form should be disregarded for substance and the emphasis should be on economic reality." *Cellular Engineering*, 118 Wn.2d 16 (1991). The purpose of the securities laws is "to regulate investments, in whatever form they are made and by whatever name they are called." *Cellular Engineering*.

3. The statutory definition of "security" found in RCW 21.20.005(12) includes the term "investment contract". The elements of an investment contract are: 1) an investment of money, 2) in a common enterprise, with 3) an expectation of profits deriving primarily from the efforts of others. *Cellular Engineering at 25.*

4. The parties agree that the focal point of the case is the third prong of the *Howey* test–"efforts of others." *SEC vs W J Howey Co.*, 328 U.S. 293 (1946). Respondents concede that the first two elements, "investment of money" and "common enterprise," are met in this case. The third prong of *Howey* is expectation of profits solely from efforts of others. The word "solely" has been written out of the law by subsequent cases that liberalize the third prong,

5. The "efforts of others" prong is satisfied if the efforts made by the promoter or a third party are the "undeniably significant ones that affected the success or failure of the investments." *Cellular Engineering* at 25. In addition, other Washington cases provide guidance as to when the third prong of the investment contract test has been met.

6. In *McClellan v. Sundholm*, 89 Wn.2d 527 (1978), Sundholm and an investor entered into an agreement whereby Sundholm would order and select silver bullion for the investor, as well as give him continuing silver investment advice. The court held the third prong of the investment contract test was met where the investor relied "on the expertise of the Company to select and purchase an appropriate grade and quantity of silver, arrange for its shipment and delivery to him, and, in the future, obtain the best price on resale."

7. In *Ito International Corp. v. Prescott, Inc*., 83 Wn.App. 282 (1996), the court held that interests in a specific general partnership were securities. Under the partnership agreement at issue in *Ito*, broad powers were given to an elected Board of Directors to manage the business (to own and operate a building in downtown Seattle), but investors retained the power to dismiss directors by a two-thirds vote and take control of the company. The court found that the

act must be liberally construed to protect investors and it was demonstrated that investors held but a passive interest because they depended substantially on the Board's management efforts.

8. In *Christgard v. Christensen*, 29 Wn.App 18 (1981), the investor relied on the expertise of the promoter while investing his money in a sawmill manufacturing business. The court held the "efforts of others" prong was satisfied where the investor was dependent upon the promoter's "production knowledge and skills, managerial expertise, and marketing experience."

9. Analysis of the "efforts of others" prong of the investment contract test may be further guided by three factors set forth in *Williamson v. Tucker*, 645 F.2d 404 (5th Cir. 1981). The court held that an interest in a general partnership or joint venture may be considered a security where:

> (a) an agreement among the parties leaves so little power in the hands of the partner or venturer that the arrangement in fact distributes power as would a limited partnership; or
>
> (b) the partner or venturer is so inexperienced or unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venturer powers; or
>
> (c) the partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers.

The Ninth Circuit has adopted the *Williamson* factors. *Hocking v. Dubois*, 885 F.2d 1449 (9th Cir. 1989). *Ito* cited approvingly the Ninth Circuit's adoption in *Hocking* of the *Williamson* factors. The *Williamson* factors have yet to be formally adopted in Washington. It is not necessary to establish that any or all of the *Williamson* factors have been

satisfied here. However, the *Williamson* factors provide further guidance in deciding whether the third prong has been met.

10. When applying the *Williamson* factors, it is proper to look "to other documents structuring the investment, to promotional materials, to oral representations made by the promoters at the time of the investment, and to the practical possibility of the investors exercising the powers they possessed pursuant to the agreements." *Koch v. Hankins*, 928 F.2d 1471 (9th Cir. 1991). Thus, whether the "efforts of others" prong is met depends not only upon the rights of control retained by investors, but also on the actual ability of investors to exercise control over the business.

11. The State posits that it appears that the issue of whether LLC interests are securities is a question of first impression in Washington. We do not find it necessary to hold that all LLC interests must be considered securities. Likewise, we do not see any Washington case which precludes finding a particular LLC to fall within the definition of security. LLC interests were held to constitute securities in Arizona. *Nutek Information Systems v. Arizona Corporation Commission*, 977 P.2d 826 (1998). The *Nutek* court applied the *Williamson* factors.

12. We conclude that the first *Williamson* factor – *whether an agreement among the parties leaves so little power in the hands of a partner or venturer that the agreement in fact distributes power as would a limited partnership* – is met with respect to all LLC investors in this case.

13. We conclude that the second *Williamson* factor–*whether the partner or venturer is so inexperienced or unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venturer powers*–has been shown with respect to at least some of the investors who testified as described in findings above.

14. We conclude that the third *Williamson* factor–*whether the partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager of the*

enterprise or otherwise exercise meaningful partnership or venture powers–is clearly met with respect to all investors. We agree with the argument of the State that the LLC investors [even the more sophisticated individuals, Hunt and Abraham] lacked substantive knowledge about viatical settlements, lacked expertise to evaluate and purchase policies, lacked general knowledge of the markets and industry necessary for success, and were so dependent on unique knowledge and expertise possessed by Mr. York and VCI as to be practically unable to replace them, notwithstanding their legal right to do so under the terms of the written agreements. Likewise, the Executive Committees of the LLCs were so dependent on unique knowledge and expertise of Mr. York and VCI as to be practically unable to replace them.

15. *SEC v. Life Partners, Inc*., 87 F 3rd 536 (DC Cir. 1996) (hereinafter "*LPI*"), which found that certain viatical settlements were not securities under the investment contract test, is inapposite because the issue in the present case is whether the offer or sale of Respondents' limited liability company interests are securities. The subject matter of an LLC, viatical settlements in the instant case, is not determinative as to whether the investment transactions in question constitute the offer and sale of a security. Furthermore, we disagree with the holding of *LPI* because it limits its analysis under the third prong of *Howey* to post-investment functions of the promoters. The *LPI* court does not include in its analysis under the third prong of *Howey,* the pre-investment efforts of the promoters, such as: 1) assembling investors, 2) evaluating medical condition of potential viators, 3) reviewing life insurance policies of potential viators, 4) negotiating purchase prices of, and purchasing, life insurance policies. We agree with the dissent in *LPI* that pre-purchase functions of promoters should be included in the "efforts of others" analysis. We hold that under *Cellular Engineering*, and the cases it cites, pre-sale efforts of promoters should be included for consideration in the analysis under the third prong of *Howey.*

16. In addition, we distinguish *LPI* on its facts. The *LPI* court, based on the record before it, states that the sole determinant of the profitability of the investment (rate of return) is how long the insured (viator) lives. The *LPI* analysis is that once the policies are purchased, the efforts of the promoters are no longer a matter of expertise upon

which investors rely. Rather, the functions after policy purchase are merely ministerial and administrative in nature. We cannot scrutinize this analysis without the entire *LPI* record, but it follows that the type of skilled post-investment services found in the present case, such as the identification and screening of viators and negotiating the purchase price of life insurance policies, must not have been present in *LPI.*

17. VCI argues that, in any event, it did not perform any of the expert functions entailed in acquiring life insurance policies as these functions were delegated to viatical settlement companies, which specialize in providing these services. While it is true that the member-managers of the LLCs were left with decisions to make, post-investment, as to which policies to buy, these decisions were akin to multiple-choice questions. VCI presented to the member-managers the several policies for proposed purchase. The investors (member-managers) relied heavily on VCI and its delegates, the viatical settlement companies, to propose policies for purchase that would pay a good rate of return. Success of the venture was heavily dependent upon these proposals, regardless of whether presented directly by VCI or whether presented indirectly through VCI from the viatical settlement companies.

18. In addition to post-investment purchase proposals, VCI from time to time proposed, post-investment, that certain life insurance policies be sold,. Similarly, investor member-managers relied upon the expertise of VCI and its president, Douglas York, to propose liquidation sales to the best advantage of the LLC ventures.

19. Unlike the scenario in *LPI*, the post-investment buying and selling of life insurance policies was significantly determinative of the profitability of the venture. The purchase or sale proposals that the LLCs received from VCI and York were not merely administrative and ministerial functions, but significant managerial and entrepreneurial profit determinative functions.

20. Neither VCI nor Douglas York, president of the company, could practically be replaced. Investors relied upon the expertise of VCI and Mr. York to select policies to buy and sell. The "efforts of others" prong is met where promoter services included "ongoing consultation and advice," as in *McClellan*.

21. Even among the more sophisticated investors who testified, Linda Hunt and George Abraham, there was reliance upon ongoing consultation and advice, including decisions regarding which viatical settlement company or companies to retain to locate policies. The member-managers' Executive Committee relied on VCI and Douglas York to provide that advice.

22. In conclusion, the "efforts of others" prong of the "investment contract" test has been met. The LLC investments in viatical settlements offered and sold by VCI and its agents in Washington should be considered "securities" subject to Washington securities laws.

B. Violations Of Law And Remedy

1. Respondents VCI and VMI violated RCW 21.20.140 by offering and selling through its agents securities–membership interests in Viatical Funding LLCs–without the securities being properly registered under chapter 21.20 RCW.

2. VCI and VMI violated RCW 21.20.040 by offering and/or selling securities thereby transacting business in this state as a securities broker-dealer or salesperson without being properly registered under chapter 21.20 RCW.

3. Respondents VCI, VMI, VIATICAL FUNDING LLC-III, VIATICAL FUNDING LLC-GI-V offered and sold LLC interests in violation of RCW 21.20.010 because they and their agents made untrue statements of material fact or omitted to state material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.

4. Pursuant to RCW 21.20.390, when it appears to the director that any person has engaged or is about to engage in any act or practice constituting violation of chapter 21.20 RCW the director may in his or her discretion issue an order directing the person to cease and desist from continuing the act or practice.

ORDER

Based upon the above Findings of Fact and Conclusions of Law it is hereby

ORDERED that, pursuant to RCW 21.20.390, Respondents VIATICAL CAPITAL, INC., VIATICAL MARKETING, INC., VIATICAL FUNDING LLC-III, VIATICAL FUNDING LLC-GI-V each shall permanently cease and desist from any and all acts or practices in violation of RCW 21.20.010, 21.20.040, and 21.20.140.

WILLFUL VIOLATION OF THIS ORDER IS A CRIMINAL OFFENSE.

DATED this _____ day of November, 2001.

/s/ *John L. Bley*
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JOHN L BLEY
Director, Department of Financial Institutions

Presented by:

/s/ *William M. Beatty*
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William M. Beatty
Reviewing Officer