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Court Says Certain Life Settlement Transactions are Not “Securities” for Purposes of Rule 10b-5

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The US District Court for the Northern District of Illinois ruled that proposed investments in life settlements by a single purchaser (as opposed to investors in a pooled transaction) are not securities for purposes of SEC Rule 10b-5's prohibition against manipulative or deceptive practices.

In a memorandum opinion and order issued Monday, September 27, 2010 in *Zang v. Alliance Financial Services Of Illinois, Ltd.*, that court determined that an investor who paid a financial services company a retainer and fees to arrange life settlements and surety bonds to serve as collateral for a financing whose proceeds could be used by this investor to fund his purchase of a another business had not made a valid federal securities law claim in relation to the refusal of that company to refund such amounts though it had failed to complete those transactions.

Facts of the Case

In June 2007, John Zang contacted Alliance Financial Services of Illinois, Ltd. (“Alliance”) in response to an advertisement promising companies for purchase with no principal payments. Alliance represented to Zang that it would use its best efforts to locate a company for Zang to purchase and would arrange financing for the purchase in exchange for a fee on closing and an upfront refundable retainer of \$5,000. The financing would involve

purchasing life settlements. The proposal also involved purchasing surety bonds for these policies to ensure maturity within seven years, and then pledging these policies and surety bonds as collateral for a bank loan.

Alliance failed to locate suitable companies and Zang found those for himself. Zang instructed Alliance to pursue purchases of each. Alliance insisted Zang fund an additional \$32,500 to cover down payments for the purchases and to fund Alliance's efforts to obtain financing. Neither deal was consummated and Alliance refused to refund any of the \$37,500 Zang had paid. In June 2008, Zang filed a complaint against Alliance and its president alleging violations of state laws and federal laws, including Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5. He alleged Alliance and its president had made material misstatements and engaged in deceptive acts in connection with the purchase or sale of securities—namely the life settlements that Alliance failed to arrange. The court found that Zang failed to state a claim under Section 10(b) and Rule 10b-5, but allowed him to amend his pleading of fraud under the Exchange Act.

The Court's Analysis

Rule 10b-5 prohibits the making of any untrue statement of material fact, or the omission of a material fact that would render statements made misleading, in connection with the purchase or sale of any security.¹ The Court's analysis focused on whether the alleged misstatements were "in connection with the purchase or sale of securities."

To be a "security" for purposes of the Exchange Act a life settlement would have to be an "investment contract."² The Supreme Court formulated a definition for "investment contract" in the case *SEC v. W.J. Howey Co.*³ Under the "Howey test" an investment contract is a contract, transaction or scheme whereby (1) a person invests money (2) in a common enterprise and (3) is led to expect profits produced solely by the efforts of others. The key issue in the *Zang* case was whether a life settlement met the "common enterprise" requirement of the Howey test.

Courts in different jurisdictions use either of two tests for this "common enterprise" requirement. Zang advocated for the use of the "vertical commonality" test applied by Illinois state courts and the Fifth and Ninth Circuits, which requires that the fortunes of the investor are interwoven with those of the investment promoter. But the Court stated that it was constrained to use the "horizontal commonality" test prescribed by the Seventh Circuit (and other circuits), under which multiple investors must pool their investments and receive pro rata profits. Defendants contended, and Zang admitted, that he had not shared or otherwise pooled his money with other investors to generate a profit collectively, and therefore that he had not pleaded facts to satisfy the common enterprise requirement under a horizontal commonality test. The Court agreed, and found that Zang's

allegations did not satisfy the common enterprise requirement of the Howey test.

We find this outcome to contrast in very interesting ways with the recent guidance of the SEC about circumstances in which life settlements are securities, and caution readers that courts in other jurisdictions may not apply the same test or reach the same conclusions this court did when this issue is presented in other life settlements related transactions.

Endnotes:

1. 17 C.F.R. § 240.10b-5.
2. 15 U.S.C. § 78c.
3. 328 U.S. 293, 298 (1946).

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