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LEGAL ALERT

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Cost of Insurance Litigation – Recent Rulings Diverge on the Scope of Insurer Discretion to Set Rates

Litigation continues in various cases challenging cost of insurance rates (COI) in life insurance policies, and January 2013 saw courts issue decisions going both ways on insurer discretion to set and modify COI rates. A federal district court in California held that changes to COI rates cannot be "wholly divorced" from changes in mortality experience. In Wisconsin, a federal district court held that an insurer had broad discretion to set COI rates regardless of the factors considered, as long as the rates did not exceed the guaranteed maximum rates. And an Indiana state trial court has denied a motion to dismiss in a COI case, holding that the COI provision was ambiguous and should be interpreted in favor of the insured.

This Legal Alert discusses these decisions and also reports on other ongoing developments in litigation challenging COI charges. The complaints in the COI cases generally allege that COI rates must be based solely on mortality factors, as defined by plaintiffs (e.g., age, sex, underwriting class), and cannot be increased or set based on other non-mortality factors. These three recent rulings continue a trend of mixed decisions on COI issues.

A California Federal Court Holds That COI Increases Cannot Be Divorced From Mortality Experience

On January 29, 2013, a federal district court in California denied the insurer's motion for summary judgment and partially granted the plaintiffs' cross motion in ongoing multidistrict litigation challenging COI rate increases. *In re Conseco Life Insurance Company LifeTrend Insurance Sales and Marketing Litigation MDL*, No. 3:10-md-2124 (N.D. Cal Jan. 29, 2013) (Please click here for the opinion.) The court also denied the insurer's motion to decertify the class. The plaintiffs alleged the insurer improperly sought to increase COI rates based on factors other than mortality, including for the purpose of recouping past losses. The court certified a national class on October 6, 2010 (which was later partially decertified as to former policyholders), and on July 17, 2012, entered a preliminary injunction enjoining COI increases against certain policyholders pending final resolution. In entering a preliminary injunction, the court held that changes to COI rates were contractually tied to changes in mortality rates and that the plaintiffs were therefore likely to prevail on the merits of their breach of contract claim.

In its recent decision, the court first granted summary judgment to the plaintiffs on the issue of whether the insurer breached the terms of the policy by considering duration—i.e., how long a policyholder has owned a policy—in raising COI rates. The policy provided that "[t]he monthly cost of insurance rates, and any change in the monthly cost of insurance as provided herein, are and will be determined on a uniform basis for insureds of the same age, sex and classification for all policies issued with like benefits and provisions." Under the rate increase structure, the rate for some policyholders would differ based on how long they had held the policy. In interpreting the contract, the court found that considering the duration of a policy was not provided for in the agreement and was therefore not permitted.

On the remaining contract issues, the court held as a legal matter that COI rate increases could not be "wholly divorced" from mortality rates and held that there was a triable issue of fact as to whether the insurer had breached the policy. In interpreting the contract, the court found that the term "cost of insurance" was ambiguous because the contract did not explicitly define the term, but rather merely set

general parameters such as a maximum. The court found that because the table setting forth the maximum charges was entitled, "Guaranteed Maximum Monthly Mortality Charge," the contract used "interchangeably" the terms "cost of insurance rates" and "mortality charge," reflecting that the insurer "considered the terms at least connected, if not interchangeable." Finally, the court stated that any remaining ambiguity in the contract should be resolved against the insurer and held that changes to COI rates could not be wholly divorced from mortality rates. As a factual matter, the insurer disputed that the rate increases were wholly divorced from mortality, and disputed the extent to which interest rates or other factors played a role in the insurer's crafting of new rates. Because the court found that plaintiffs had not shown, indisputably, that the motives for recrafting rates were wholly divorced from mortality rates, the court held that summary judgment on this issue was not appropriate.

A Wisconsin Federal Court Holds That Insurer Has Broad Discretion in Setting COI Rates

In another recent decision, a federal district court in Wisconsin granted summary judgment in favor of an insurer and held that the COI provision in a universal life policy "does not impose any contraints on the process [the insurer] uses to set its cost-of-insurance rates." *Thao v. Midland National Life Insurance Company*, No. 2:09-cv-01158-AEG (E.D. Wisc. Jan. 9, 2013) (Please click here for the opinion.) In this case, the plaintiff brought a putative class action challenging the setting of COI rates on the basis that the insurer allegedly considered factors unrelated to mortality expectations. The plaintiff argued that the insurer was required to set COI rates "based on" five listed factors commonly associated with mortality—issue age, policy years, sex, amount, and premium class—and was not permitted to consider other factors.

The court rejected the plaintiff's claims and held that the insurer had broad discretion to set COI rates up to the guaranteed maximum rates. The insurance company conceded that it considered additional factors in setting rates, including expenses, and argued that it had discretion to do so under the policy. The court agreed, holding that this was a reasonable interpretation of the policy language, and compared the situation to a shipping company that informed a customer that its rates were "based on" the size, weight, and destination of a package. The court reasoned that "the customer [sending a package] would understand that what the company meant is that it has a pricing schedule that is organized by size, weight, and destination—not that the company considered only size, weight and destination when setting the rates that appear on the schedule. The customer would understand that the shipper had to consider a wide range of factors when setting its rates, such as the cost of fuel, employee salaries, competitor's prices, and the need to earn a profit."

This insurance policy was similar, according to the court, and there was "absolutely nothing in the language of [the] policy stating that there must be some precise relationship" between the factors considered and the elements of the policy. The court also reasoned that if the insurer "had simply plugged the applicable guaranteed maximum rate into its cost-of-insurance formula each month, the result would be a cost-of-insurance charge that reflects a mortality risk," and since the current COI rates

were below the maximums, the current rates "cannot in any reasonable sense be thought to exceed an amount that reflects a mortality risk."[1]

Other Developments

Other courts are also continuing to consider these issues. In particular, the U.S. Court of Appeals for the Seventh Circuit has recently heard oral argument in the appeal of a district court's decision to grant summary judgment for an insurer in a COI putative class action. *Norem v. Lincoln Benefit Life Company*, 2012 WL 1034495, No. 1:10-cv-2233 (N.D. Ill. Mar. 20, 2012). The plaintiff brought claims for breach of contract, alleging that COI charges should be based solely on mortality factors. In granting summary judgment, the court applied dictionary definitions of "based on" and held that the language in the contract setting the COI rates "based on the insured's sex, issue age, policy year, and payment class" meant that those factors are the foundation, principal components, or fundamental ingredients of the COI rates, but not the exclusive factors to be considered in setting those rates. The district court held that "[s]o long as the rates remained below the guaranteed rates, defendant had discretion in setting those rates under the policy." The district court opinion discussed two earlier COI decisions favorable to the plaintiffs, including *Yue v.Conseco Life Ins. Co.*, No. CV 08-1506, 2011 WL 210943 (C.D. Cal. Jan. 19, 2011) (click here for Sutherland Legal Alert), and *Jeanes v. Allied Life Ins. Co.*, 168 F. Supp. 2d 958 (S.D. Iowa 2001). However, to the extent *Yue* and *Jeanes* deem "based on" to mean "solely based on," the court stated it was declining to adopt their view. The plaintiff in *Norem* appealed, and the case was argued in the Seventh Circuit on October 22, 2012.

Earlier this year in a different case, a Ninth Circuit panel revived certain COI claims in a putative class action alleging improper COI rates and allowed the plaintiffs to file an amended complaint reasserting state law contract claims. *See Freeman v. Pacific Life Insurance Co.*, No. 09-55513 (9th Cir Jan. 2, 2013) (click here for a copy of the opinion). The district court had dismissed the complaint as being precluded by the Securities Litigation Uniform Standards Act (SLUSA). The plaintiffs had alleged in a putative class action that the defendant insurer set improper COI rates on variable universal life insurance policies by charging COI "in excess of true mortality charges" rather than "based on industry accepted actuarial determinations." The plaintiffs contended that defendant breached the insurance contract by considering factors in addition to mortality in setting COI rates.

The Ninth Circuit reversed, in part, holding that the class claims for breach of contract and breach of the duty of good faith and fair dealing were not precluded by SLUSA, even if such claims related to the purchase or sale of a covered security, because the contract claims did not rest on a misrepresentation or fraudulent omission. SLUSA bars class actions brought under state law, whether styled in tort, contract or breach of fiduciary duty, that in essence claim misrepresentation or omission in connection with certain securities transactions. See 15 U.S.C. § 78bb(f)(1). Preemption did not apply to the contract claims in

[1] The order granting the insurer's motion for summary judgment was issued in the context of an individual action, because the court had previously denied a motion for class certification in the case. *Thao v. Midland Nat. Life Ins. Co.*, 09-C-1158, 2012 WL 1900114 (E.D. Wis. May 24, 2012). The court denied class certification on the grounds that the proposed class "does not comprise policyholders with a common grievance." The court had examined the policy pricing structure in detail, and found that "the design objectives for those policies called for charging a cost-of-insurance rate that is higher than expected mortality in early policy years in exchange for charging a rate that is lower than expected mortality in later policy years." Because of this pricing structure, the plaintiff could not show that "all class members would pay lower cost-of-insurance rates than they do now if [the insurer's] rates were based exclusively on the five factors listed in the policies." The court found that "many class members would prefer [the insurer's] interpretation of the policy language to [the plaintiff's]," and therefore a class could not be certified.

this case, the Ninth Circuit held, because "[t]o succeed on this claim, plaintiffs need not show that [the insurer] misrepresented the cost of insurance or omitted critical details. They need only persuade the court that theirs is the better reading of the contract term." The court reversed the district court's dismissal of the two contract claims, on the condition that plaintiffs amend the complaint to remove any reference to deliberate concealment or fraudulent omission. The Ninth Circuit affirmed the dismissal, under SLUSA, of claims brought under the California Unfair Competition Law. The court did not consider the merits of the COI issues, which apparently will now be repleaded in the district court.

An Indiana state trial court recently denied a motion to dismiss in a putative class action alleging breach of contract in the setting of COI rates under a variable universal life insurance policy. *Bezich v. Lincoln National Life Ins. Co.,* 02C01-0906-PL-73 (Allen County Circuit Court, Indiana Jan. 14, 2013) (click here for a copy of the opinion). The plaintiff alleged that COI could only be "based on" mortality factors, including sex, issue age, policy year, and rating class. The court noted that other courts had reached different interpretations of the phrase "based on" in previous COI cases, and the court relied on this history to conclude that the phrase was ambiguous. The court held that an ambiguous provision should be interpreted in favor of the insured, and therefore denied the motion to dismiss the contract claims. The court stated that "[i]f the Court were to give this provision its plain and ordinary meaning, an ordinary policyholder would interpret that provision to mean the COI charge is limited to [mortality] factors and those factors only." The court also rejected the insurer's argument that the claims should be dismissed as barred by the statute of limitations.

At the state administrative level, an insurer has recently received a favorable decision from the Maryland Insurance Commissioner, holding that the insurer did not violate the Maryland Insurance Code in its handling of a flexible premium variable life insurance policy. *Maryland Ins. Admin. ex rel. L.C.G. v. Axa Equitable Life Ins. Co.* (Md. Ins. Dept. Jan. 11, 2013) (click here for a copy of the opinion). An insured had filed a pro se administrative action after the carrier increased COI charges. An administrative law judge reviewed the issues and issued a proposed decision finding no violation of the insurance code, which was affirmed by the Commissioner on January 11, 2013.

Conclusion

As these developments reflect, courts are continuing to reach different conclusions on COI issues, though some of variation may be the result of specific contract language and other facts pertaining to individual cases. More decisions are expected in the year to come.

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If you have any questions regarding these developments, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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