WINSTON & STRAWN LLP

CLIENT ALERT

How To Prepare For The Next Wave Of UL Class Actions

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Flexible premium adjustable life insurance policies – more generally known as "universal life" insurance ("UL") policies – contain many adjustable elements. For the insurer, perhaps the most important is the price of the base coverage, the most critical component of which is the policy's cost of insurance ("COI") rate. To put it another way, UL policies permit insurers to increase the price of coverage after issuing the policies by raising COI rates.

Life insurers should no longer be surprised if class action litigation ensues when they increase the price of UL coverage by raising COI rates after the policies have been in force for a number of years. A clear pattern has emerged: following a price increase, some policyholders sue for breach under a theory that the insurer raised the price in violation of policy provisions. They also ask the court to certify their contract claim (among others, perhaps) for class treatment, based on the fact that the price increase was implemented uniformly for all policies in the UL book. In fact, UL policy forms invariably require COI rate increases to be implemented uniformly for insureds who are similarly situated based on underwriting criteria. Breach of contract claims that survive dispositive motions are generally certified for class treatment.[1]

None of this should be news for issuers of UL policies contemplating a price increase.

But here's the news: we have been informed by attorneys in the plaintiffs' bar that they are now planning to bring class actions against issuers of UL policies for not only their actions in raising COI rates, but also their inactions in failing to lower COI rates where provisions in the UL policy form suggest (or require) that insurers review and re-determine COI rates periodically. The plaintiffs' bar will argue that, although nationwide mortality rates have declined significantly over the past several decades, life insurers with an obligation to periodically review and re-determine COI rates have enriched themselves by failing to lower COI rates that plaintiffs consider outdated and excessive.

As we discuss in this article, you can take several steps now to prepare for this coming wave of UL class actions:

- You can inventory your UL books of policies to determine which have provisions that plaintiffs may claim create a duty to review and re-determine COI rates. Below, we identify a number of sample provisions in UL policy forms that the plaintiffs' bar may target;
- You can then review the factors identified in the policies that insurers may or must consider when they are reviewing COI rate levels. Below, we show that courts construing these UL policy provisions have based their

interpretations on whether the policy (a) requires that only one factor be considered, (b) permits multiple factors to be considered, or (c) is silent on the factors the insurer is to consider; and

- You can recognize that you already have a process – the annual asset adequacy analysis – that can be used as the platform from which you can conduct any review of COI rates for the UL policies that plaintiffs may target. Below, we discuss how and why the annual asset adequacy analysis provides you with the springboard for preventing the plaintiffs' bar from achieving success on a claim that your company breached UL policy obligations by failing to review or re-determine COI rates.

Sample UL Policy Provisions that the Plaintiffs' Bar May Be Targeting

We have reviewed a multitude of UL policy forms with the goal of identifying the kinds of provisions that the plaintiffs' bar may be targeting for future class actions. We set forth below sample provisions in UL policy forms that run the gamut, in descending order, from explicitly requiring the insurer to review and reset COI rates periodically to implicitly suggesting that a periodic review and re-determination process is required (all emphases added):

- That the insurer will "*review COI rates at least once every five years* to determine if a change should be made";
- That the insurer "*[f]rom time to time, . . . will consider the need to change the [COI] rates we charge*";
- That the insurer "*will determine [COI] rates from time to time*. Any change in the cost of insurance rates will be based on a number of factors . . .";
- That the insurer's "*[m]onthly [COI] rates will be set [or "determined," in some variations] by us from time to time*, based on . . . ";
- That "*[t]he actual [COI] rates and method of calculation will be set by us, in advance, at least once a year*. Any change in the [COI] rates and method of calculation will be uniform and based on . . . "; and
- That, *"[a]t the start of each policy year, we will set the "Monthly [COI] Rate"* used to calculate the Monthly [COI] charge for your Policy."

Thus, the first step for any life insurer seeking to minimize its exposure to the class action risk from this new wave of litigation is to inventory its books of UL policies and identify provisions such as these that plaintiffs may target as giving rise to an obligation to periodically review and re-determine COI rates.

The Factors that Insurers May or Must Consider in Reviewing COI Rates Periodically

Our review of a multitude of UL policy forms and the case authorities construing them has revealed that the forms may be categorized into three groups for purposes of examining the factors that insurers may or must consider when reviewing and re-determining COI rates:

- **The Single Consideration Policy Form**, which provides that any change in COI rates must be based on one and only one consideration, namely, the insurer's "expectation as to future mortality experience";
- **The Multiple Consideration Policy Form**, which provides that the insurer's review and re-determination of COI rates may be based on a number of considerations, which almost always includes its "expectations as to future mortality, lapse (or persistency), expense, and/or investment income experience," and sometimes continues by adding considerations such as "taxes, profitability, and market conditions." The Multiple Consideration Policy Form generally lists these considerations as being non-exclusive, which increases the scope of an insurer's discretion; and
- **The Silent Policy Form**, which contains no provisions as to the factors that the insurer may or must consider in reviewing and re-determining COI rates. The Silent Policy Form explicitly identifies the maximum COI rate scale

that applies to the policy, mentions that the insurer may apply "current" or "monthly" COI rates that are lower than the specified maximum COI rates, and generally states that the insurer has discretion as to where to set those current or monthly COI rates, but without identifying the factors or considerations that the insurer may or must apply in setting lower-than-maximum COI rates.

Case authorities have emerged interpreting each of these groups of policy provisions, and the pattern flowing from the decisions is hardly surprising. The Single Consideration Policy Form has been interpreted as restricting the insurer's discretion in changing COI rates to consideration of only its "expected future mortality experience" and nothing else.[2] One of these authorities went so far as to interpret the word "mortality" to mean expected "mortality rates" only, as opposed to other mortality considerations such as the number of expected future deaths of insureds or the amount of expected future mortality payments.[3] We view that interpretation to have been overly restrictive. Moreover, that decision was later vacated as part of a settlement.[4]

The Multiple Consideration Policy Form has been interpreted as providing insurers with ample discretion in the reviewing, setting, or changing of COI rates, and we are not aware that any insurer's raising of COI rates has ever been successfully challenged when the insurer's COI rate increase was governed by the Multiple Consideration Policy Form.[5]

The Silent Policy Form has been interpreted only once, to our knowledge, and that interpretation was not definitive for several reasons.[6] First, although the court ruled that the absence of any policy provisions identifying the factors that the insurer could or must consider in raising COI rates created a policy ambiguity that was to be construed against the insurer, the court did not fully develop a policy interpretation based on the deemed ambiguity. Rather, the court left further interpretation for another day, noting only that the insurer's decision to increase COI rates should not be "wholly divorced from mortality rates."[7] Second, that further interpretation was not forthcoming, as the case settled and the decision was vacated as part of the settlement.[8]

Thus, any life insurer seeking to minimize its exposure to this new wave of class action risk should be mindful of whether each of its UL policy forms uses the Single Consideration, Multiple Consideration, or Silent Policy Form.

The Annual Asset Adequacy Analysis Provides an Opportunity for Reviewing COI Rates

In 1991, the National Association of Insurance Commissioners (the "NAIC") adopted a Model Actuarial Opinion and Memorandum Regulation (the "Model Regulation"). The Model Regulation has been amended several times since, but some version of it has been enacted into law in every state and the District of Columbia.[9] The Model Regulation applies to all life insurers that either do business or are authorized to reinsure life insurance in a given state.

The operations that an insurer must conduct to comply with the provisions of the Model Regulation provide it with a natural opportunity for it to simultaneously review the COI rates for any books of UL policies that plaintiffs may target.

The Model Regulation requires life insurers to annually conduct an asset adequacy analysis (the "Analysis"), which ultimately results in the insurer's Appointed Actuary issuing an opinion as to whether the insurer's assets are adequate to support its liabilities. Specifically, the Appointed Actuary is required to opine on whether the insurer's reserves make adequate provision, under presently accepted actuarial standards of practice, for the anticipated cash flows required by the insurer's policy obligations and other expenses.

The Analysis is the outcome of a laborious, time-consuming, and complex process, including the cash flow testing procedures that precede it. That process requires the insurer, among other things, to examine each of its actuarial assumptions and methods used in determining reserves, including its reserves for all books of UL policies. The reserves for UL policies and other products must not only take all relevant policy provisions into consideration – including the UL policy provisions that plaintiffs may target – but also be computed based on assumptions

consistent with those used in computing the corresponding items in the insurer's annual statement, known as the "blue book," that is annually filed with insurance regulators.

The Model Regulation requires the insurer to describe and document its Analysis by the preparation of an annual Actuarial Memorandum. The Actuarial Memorandum must demonstrate that the Analysis was performed in accordance with the standards set forth in the Model Regulation. Among other things, the Memorandum must detail, for each product and the reserves established for each product, the sources of liabilities for each in-force block and the assumptions used to test reserves. Those assumptions include the insurer's mortality, lapse (or persistency), investment income, and expense assumptions. Those assumptions are largely predicated on the insurer's historical experience for each of these elements, along with an added component of how the insurer expects that future experience for each element may deviate from its historical experience.

This is precisely the point at which the operations required to perform the Analysis overlap with the considerations that an insurer may or must consider in reviewing and re-determining (or not) its COI rates for UL books of policies that the plaintiffs' bar may target. As part of the Analysis, the insurer will already be collecting and analyzing the data that is needed for the insurer to analyze the future or expected profitability (or lack thereof) of its UL books of policies, so the time would also seem opportune for the insurer to consider the elements that it arguably may or must consider when conducting a periodic review of its COI rates for UL policies. Thus, the annual operations leading to the preparation of the Analysis present the life insurer with the natural opportunity to perform any review of COI rates in its UL books of policies that plaintiffs may target.

Although insurers should document the occasions on which they conduct such a review of COI rates, the documentation of the COI rate review process should not be included in the Actuarial Opinion and Memorandum that is mandated by the Model Regulation. Rather, insurers should avoid any confusion as to the separate purposes behind the COI rate review and the Analysis by documenting any COI rate review separately from the Actuarial Opinion and Memorandum.

1 *See, e.g., Fleisher v. Phoenix Life Ins. Co.*, No. 11-cv-08405 (CM), 2013 WL 4573530 at *1 (S.D.N.Y. Aug. 26, 2013); *Yue v. Conseco Life Ins. Co.*, 282 F.R.D. 469, 481 (C.D. Cal. 2012); *Yue v. Conseco Life Ins. Co.*, No. CV 08-1506 (AHM), 2011 WL 210943 at *1 (C.D. Cal. Jan. 19, 2011); *In re Conseco Life Ins. Co. Lifetrend Insurance Sales and Marketing Litig.*, 270 F.R.D. 521, 528-33 (N.D. Cal. 2010); *Beller v. William Penn Life Ins. Co. of New York*, 37 A.D.3d 747, 748, 830 N.Y.S.2d 759, 760 (N.Y. App. 2007).

2 *Yue, supra*, No. CV 08-1506 (AHM), 2011 WL 210943 at * 9-10; *Jeanes v. Allied Life Ins. Co.*, 168 F. Supp. 2d 958, 973-74 (S.D. Iowa 2001), *rev'd in part on other grounds*, 300 F.3d 938 (10th Cir. 2002).

3 *Yue, supra*, No. CV 08-1506 (AHM), 2011 WL 210943 at * 9-10

4 We represented the insurer in the *Yue* cases discussed in footnotes 1 through 3.

5 *See, e.g., Norem v. Lincoln Benefit Life Co.*, 737 F.3d 1145, 1154-55 (7th Cir. 2013) (life insurer's setting of COI rates under the Multiple Consideration Policy Form should be interpreted so as to permit the insurer to "make a profit" on its policies); *Thao v. Midland Nat'l Life Ins. Co.*, No. 09-C-1158, 2013 WL 119871 at *1-2 (E.D. Wis. Jan. 9, 2013), *aff'd*, 549 Fed. Appx. 534 (2013); *Coffman v. Pruco Life Ins. Co.*, No. 10-CV-03663 (DMC), 2011 WL 4550152 at * 3-4 (D.N.J. Sept. 29, 2011).

6 *See In re Conseco Life Ins. Co. Lifetrend Insurance Sales and Marketing Litig., supra*, 920 F. Supp.2d at 1062.

7 *Id.*

8 We represented the insurer in the *Lifetrend* case discussed in footnotes 1, 6, and 7.

9 For the sake of simplicity, we will discuss the terms of the Model Regulation, as opposed to the terms of the many state law variations of the Regulation that have been enacted. The state law variations are not material for purposes of this article.

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