

Annuity and Life Insurance Sales Practice Class Actions

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I. Annuity Sales

The sale of various forms of annuity contracts as retirement and savings vehicles has been around for many years. Originally, Congress was faced with whether or not to include the regulation of annuities as investments under the Securities Act of 1933. Eventually Congress decided that with the wide regulation of insurers and banks for annuities they would be exempt from the 1933 Act.¹

This paper will focus primarily on deferred annuities. In summary, an annuity is a contract between the consumer (“annuitant”) and an insurance company in which the annuitant makes an upfront payment, or series of payments into the product. In return, the insurance company guarantees a lump sum payment or series of payments for a specified period of time.

A deferred annuity is an annuity contract which accumulates tax-deferred until such time as the contract matures (or “annuitizes”), and is eventually distributed in either a series of payments or in lump sum fashion. Typically the chief use of a deferred annuity is to provide long term growth for the annuitant’s savings.

More specifically, a fixed deferred annuity is one that grows by interest alone. The underwriting insurance company offers the annuitant a guaranteed rate of return. Many deferred fixed annuities do not have a fixed rate of return for the entire life of the contract, but rather, a guaranteed minimum rate for a short duration, often coupled with a “bonus” or “enhancement”.

¹ 15 U.S.C.A. §77c(a)(8).

These features are used by insurance companies as a teaser to attract investors. In a typical deferred fixed annuity, the annuity contract will contain a 3% minimum guaranteed interest rate, a 1% bonus rate to be credited in year-one, and an adjustable rate after a specific period of time. Deferred annuities usually have an initial interest rate guarantee period of one to five years. During the guarantee period, the insurance company guarantees the interest rate and thereafter it fluctuates subject to the minimum guarantee. Also prevalent in this type of annuity are maintenance fees, administrative fees and/or surrender charges. The surrender period can range from five to nine years in most products.

II. Recent Annuity Class Litigation

A. *Sayer v. Lincoln National Life Insurance Company*

The *Sayer* case was filed in the United States District Court, Northern District of Alabama, 05-CV-1423. The *Sayer* case brought class action allegations against the defendant for fraudulent misrepresentations, failure to disclose, negligence, wantonness, breach of contract, conspiracy and breach of fiduciary duty. Defendant's motion to dismiss all counts was denied. After the parties agreed to address the class representative's claims on the merits, conducted extensive discovery, the court entered an order granting summary judgment on the individual plaintiff's claims on October 12, 2006. Thereafter the parties reached an agreement to toll the class claims pending resolution of an appeal. On October 30, 2006 the plaintiff filed an appeal in the United States Court of Appeals for the Eleventh Circuit. The appeal is pending.

The gist of the claims brought in *Sayer* involve the design, development and sale of bonus annuities. In summary, *Sayer* alleges that the defendant sold her an annuity, as an investment, for which they contractually guaranteed her a permanent 1% interest rate bonus to be paid in year one. Even though the plaintiff agrees that the 1% bonus was credited to her account

value in year one, she alleges that the defendant began “recouping” the 1% bonus, undisclosed to her, in year two. In fact, the undisputed evidence in the case proves that the defendant used a secret actuarial pricing formula that built in an undisclosed spread (beginning in year two) which unilaterally recouped twenty basis points of interest per year for five straight years equating to a full 100% recovery of the 1% bonus previously credited.

The defendant claims: (1) the 1% bonus rate was credited in year one to the plaintiff’s account value as promised and (2) the plaintiff received everything contractually guaranteed under the contract. Testimony from the defendant’s former chief actuary (who designed the product) revealed that the company intentionally designed the annuity to recoup the year one bonus through the undisclosed basis point spread in years two through six. The defendant claims this process is not illegal nor a violation of the contractual terms of the annuity. The defendant claims they had no obligation to tell the plaintiff of the recouping process. If the defendant in *Sayer* had chosen not to recoup the year one bonus, then the testimony is undisputed that the plaintiff’s account values would be greater than they are with the current actuarial pricing formula in place. In fact, experts revealed that the plaintiff would have a higher accumulation value in a non-bonus annuity.

Further testimony which was developed indicates that neither the marketing arm of the company nor the banks (the agents) through which the annuities were sold, were ever aware of the undisclosed actuarial pricing formula which recoups the year one bonus. The question becomes, is there a duty on the part of an insurance company to disclose this pricing function to their customer? Is it fair to withhold such information from customers?

The plaintiff claims that tell a “half-truth” is the same thing as not telling the truth all together. The Eleventh Circuit will have the opportunity to make a ruling as to whether the

defendant in *Sayer* breached the contract and owed a duty to annuitants to disclose the secret recouping process which occurs in years two through six. If the Eleventh Circuit finds for the plaintiff on this issue, it will be a clear indication that telling a half-truth is fraudulent conduct. A favorable ruling for the plaintiff will indicate there is a heightened duty for full pricing disclosure on the part insurance companies designing and marketing annuity investments.

There are other similar bonus annuity cases pending around the country. At the time of writing this paper, the author is aware of the following: *Cirzoveto v. AIG*, Western District of Tennessee; *Maria Smith v. John Hancock*, Eastern District of Pennsylvania; *Delaney, et al. v. American Express Company and American Enterprise Life Insurance Company*, District Court of New Jersey. This type of litigation is early on but seems to be part of the trend sweeping the country against insurance companies and their annuity products.

B. Annuity Suitability Litigation

In *Donovan v. American Skandia Life Ins. Assur. Corp.*, 96 Fed.Appx. 779 (2d Cir. May 14, 2004), the plaintiffs brought allegations against the defendants in the Southern District of New York alleging violations of the Securities Exchange Act of 1933 and Securities Exchange Act of 1934. The basic claim brought by the plaintiffs was the defendants misled investors in a prospectus for the deferred annuities that suggested the annuities would be appropriate vehicles to fund qualified retirement plans. The plaintiffs allege the failure of the defendants to inform investors that the deferred annuities would not provide an additional tax benefit, due to the fact that qualified retirement plans are already deferred, was a violation of securities laws. Eventually the Second Circuit Court of Appeals affirmed the lower court holding that there was no duty to include the warning suggested by the plaintiffs in a prospectus. The court went on to note that the prospectus challenged by the plaintiffs did not recommend the purchase of the

annuities, but rather, only suggested that the annuities may be suitable investments in some instances.

In *Johnson v. Aegon USA, Inc.*, 355 F.Supp.2d 1337 (N.D.Ga. 2004), the plaintiff brought claims that were similar to those brought in *Donovan, supra*. The general allegations made by the plaintiffs were that the deferred annuities developed and sold by Aegon were not appropriate investments to be placed into qualified retirement plans. The plaintiffs in *Johnson* also claim that their deferred annuities were already tax deferred, the placement of the deferred annuities into qualified retirement plans did not provide them with any additional tax benefit and furthermore caused them to incur increased costs without the additional benefit. Interestingly, the plaintiffs in *Johnson* did not allege fraud, but rather, claims of innocent, negligent and/or grossly negligent conduct against the defendant. Eventually the court denied the defendant's motion to dismiss rejecting their reliance on *Donovan, supra*. The court concluded that the litigation was too early on to make a true determination of the "warning language" being challenge in the prospectus by the plaintiffs.

In *Cooper v. Pacific Life Insurance Co.*, 329 F.R.D. 245 (S.D.Ga. 2005), the Southern District of Georgia granted the plaintiff's motion to certify a class of variable annuity owners. The plaintiffs claimed the defendants failed to properly disclose tax consequences and the suitability of their investments. In that case, the court held that under Rule 10-b(5), the defendants may be liable for the failure to make adequate tax shelter disclosures within the prospectus used in the sell of their products. The court furthermore held that under Rule 10-b(5) the defendants may also be held liable for suitability omissions.

III. Juvenile Life Insurance Policies

Many Americans purchase policies either directly on their minor children or as “riders” on the parent’s life insurance coverage. Quite typically the children are insured from \$10,000 to \$50,000 while they are minors to protect against burial costs or as an accumulation policy for which ownership can later be transferred to the child once reaching the age of majority.

Many insurance companies today have tied the premium rate charged on insured minor children to that of an adult smoker rate. Insurance companies typically do not disclose the premium rate class for which juveniles are charged. Recently, litigation has been brought alleging that some major insurance companies in the United States are charging “smoker rates” for policies which cover the lives of juveniles, the vast majority of which do not smoke. In fact, there are allegations of smoker rates being charged to new borns, five year olds and teenagers who have no smoking history. These smoker rates are charged to juveniles even in light of policy applications taken on their lives at the inception of the policies clearly indicating the minors are “non-smokers”. Upon reaching the age of majority, if the coverage is still in place, many insurance companies do not differentiate the premium class at that point. Although some insurers send questionnaires at the age of majority specifically inquiring as to the insureds smoking status, many do not inquire about this information from their insureds.

A. *Thompson v. American General*

In *Thompson*, United States District Court for the Middle District of Tennessee, the plaintiff brought claims against the defendant for charging juveniles on smoker rates.² The basic claim asserted by the plaintiff in that case is the defendant charges adult smoker rates to the premiums for juvenile non-smoker insureds. Plaintiff alleged that even though the application

² 448 F.Supp.2d 885 (M.D. Tenn. 2006)

taken on the juvenile insured clearly indicated the child was a “non-smoker” the defendant chose to intentionally ignore that information and charge the plaintiff a smoker rate. Plaintiff alleges this increased the premiums owed on the juvenile coverage and furthermore reduced any interest and dividends declared by the defendant within the policy.

The defendant took the position that the plaintiff lacked standing to bring the class. The court denied the defendant’s motion to dismiss only as to plaintiff’s breach of contract claim. Thereafter, the plaintiff conducted discovery and filed for class certification. In response, American General opposed plaintiff’s motion for class certification and simultaneously filed a motion for summary judgment on the plaintiff’s underlying breach of contract claim. The plaintiff largely relied on the “reasonable expectation doctrine” in support of their claims. American General responded and eventually the court granted the defendant’s motion for summary judgment and dismissed the case holding plaintiff’s motion for class certification as moot.

The Middle District of Tennessee essentially held that under the terms of the plaintiff’s juvenile insurance policy, plaintiff received all the terms which were promised in the contract. The court opined that a non-smoker rate was not promised to the insured. The court concluded that the plaintiff could not have reasonably expected that the insurer would rate its policy based on terms not present in the policy language. The court ruled that it agreed with the defendant that the defendant’s questions about tobacco use in the application and plaintiff’s responses could not alone create coverage on a non-smoker basis.

B. *Richards v. AXA/Equitable Life Insurance Company*

In 2006 a class action was filed alleging that AXA/Equitable Life Insurance Company sold life insurance policies insuring juveniles based on adult “smoker rates”.³ Currently, the defendants have pending a motion to dismiss before the Southern District of New York.

The plaintiff claims that the defendant priced the coverage purchased on his young children based on rates applicable to individuals who smoke, even though the insureds were non-smoking infants at the time the policies were underwritten. Plaintiff alleges that the “juvenile smoker rate scheme” employed by the defendant caused policyholders to incur lower credited interest and dividends and/or be charged higher costs of insurance based, in part, on smoker rates. The plaintiff further alleged that the defendant carried out this scheme even in light of the fact that the underlying policy applications (which are part of the insurance contract) expressly state that the juvenile insureds did not smoke.

The defendant filed a motion to dismiss plaintiff’s claims pursuant to Rules 9(b) and 12(b)(6). The gist of the defendant’s defense centers around their assertion that no provision of the insurance contracts has been breached. More specifically, the defendant claims that the smoking status inquiries in the policy applications are merely questions and are not contractually binding terms. The defendant relies on additional language within the policy which states that any and all statements made in the applications are representations and not warranties.

Defendant represents that information such as the smoking status of an insured is merely information gathered to determine whether or not to accept the insured’s risk and provide

³ *Richards v. AXA Equitable Life Insurance Company f/k/a Equitable Variable Life Insurance Company*, 06-CV-03744, United States District Court, Southern District of New York.

coverage. In response, the plaintiff argued that the insurance policies at issue provide that the insureds are non-smokers, thus precluding the defendant from insuring them at smoker rates. In response to the smoking questions in the application forms, the plaintiff answered “no” with respect to their smoking status. This constituted an affirmative assertion that the juvenile insureds did not smoke. First, the plaintiff’s response to the smoking questions became part of the insurance contract because the defendant’s own policy provides a merger clause incorporated in the application as an integral part of the policy contract. Second, New York law imposes the *complete policy doctrine* on all insurance contracts which mandates that the entire terms of the contract are comprised of the policy, application, riders and any endorsements. *See, Massachusetts Mutual Life Ins. Co. v. Lord*, 18 A.D. 2d 69, 238 N.Y.S. 2d 222 (1st Dept. 1963). Third, the defendant’s policies do not merely reference that the insureds are non-smokers, the policies specifically require the defendant take into account the “rating class” of the insured. The defendant’s own policy requires that the cost of insurance rate be based on: sex, attained age and *rating class of the insured person*.

The Defendant in *Richards* alleges that there is no such thing as a juvenile, non-smoker rate available to the plaintiff. The defendant states that based on this “factual assertion” in their motion to dismiss (albeit unsupported by any evidence), the Southern District of New York should grant their motion to dismiss. As you can see, it appears that the Southern District of New York will have the opportunity to address, for the first time, this issue of charging juveniles a smoker rate, when they are actually non-smokers, and in light of contractual language requiring the insurer to use the rating class of the insured person in determining insurance costs.

IV. Conclusion

Litigation over annuities and life insurance policies continues on a wide spread basis within the United States. The issues and related causes of action concerning annuity investments and life insurance coverage seems to have no end in sight and is very well picking up the same speed as we saw in the 1990's.