Alert

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COZEN O'CONNOR

Small v. Allianz Life Ins. Co. of N. Am. – A "Small" Case But Huge Decision

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Life insurers operating in California can breathe a little easier this morning. Since 2021, life insurers have been facing a wave of class action lawsuits and potentially crushing liability based on alleged violations of California lapse statutes. The statutes require insurers to provide additional notice to policyowners to help avoid the unintentional lapse of their policies, as well as to give policyowners the right to designate someone else to be alerted of an impending lapse. *See* Cal. Ins. Code §§ 10113.71–.72. A panel of the Ninth Circuit, in an opinion that will be published, decided that, to merit damages or reinstatement for a failure to give notice or the right to designate, a plaintiff-policyowner must individually show that the failure by the insurer caused them to lapse their policies. *See Small v. Allianfz Life Ins. Co. of N. Am.*, No. 23-55821, --- F.4th ----, 2024 WL 5051192 (9th Cir. Dec. 10, 2024). In so doing, the Ninth Circuit has spared numerous life insurers from improper class action liability. However, as explained below, this may not be the end of this saga.

Until this decision, liability in these lapse cases seemed to many to be an unstoppable train headed directly at life insurers. When the California lapse statutes passed in 2012, they were ambiguous as to whether they would apply retroactively to policies already in force. Based on guidance from the California Department of Insurance, most insurers understood that the statutes would *not* be retroactive, and they applied the more stringent notice requirements only to policies issued after the effective date of the statutes – 2013 or later. In August 2021, however, the California Supreme Court determined that the statutes did, in fact, apply retroactively. *See McHugh v. Protective Life Ins. Co.*, 494 P.3d 24 (Cal. 2021). As a practical matter, that opened the door for plaintiffs' lawyers to argue that many insurers were not giving the mandated notice or the right to designate a third party to policyowners entitled to these rights under the *McHugh* court's reading of the statutes, and yet many policies lapsed in the meantime.

The key question since 2021 has been whether life insurers could be held strictly liable for any alleged failure (called the "violation-only" or "strict compliance" theory) or whether a plaintiff-policyowner must first show that the insurer's alleged failure caused them to lapse (called the "causation" or "subjective intent" theory). This matters quite a bit. Many life insurance policyowners will lapse their policies intentionally if they are no longer useful or cost-effective, and they rarely communicate their intent to the insurer. If liability depends on a mere statutory violation, however, policyowner intent is irrelevant — as long as the insurer failed to follow the statutes, policyowners theoretically would be entitled to reinstatement or damages. If liability depends on a plaintiff alleging and showing that their lapse was inadvertent and additional notice or designation rights would have prevented the lapse, liability becomes a question based on a policyowner's individual circumstances. This question affects whether or not liability can exist on a class basis.

In October 2021, only a little over a month after the California Supreme Court's decision in *McHugh*, a panel of the Ninth Circuit determined in an unpublished decision that insurers are strictly liable for any violation: "An insurer's failure to comply with these statutory requirements means that the policy cannot lapse." *Thomas v. State Farm Life Ins. Co.*, No. 20-55231, 2021 WL 4596286, at *1 (9th Cir. Oct. 6, 2021). *Thomas* was not a class action, but a majority of federal district courts largely relied on *Thomas*, as well as related precedent under California law regarding other types of insurance, to adopt strict liability and certify class actions accordingly.

On December 10, a different panel of the Ninth Circuit repudiated *Thomas* and found that plaintiffs need to show causation — i.e., that the insurer caused the lapse of their policies. The Ninth Circuit gave six reasons for its decision: (1) "the Statutes contain no private cause of action and thus require a breach of contract theory for which causation is a key element"; (2) there were indications

in *McHugh* and its related appellate decisions that causation was required; (3) there are no contrary California appellate decisions; (4) a minority of district courts did adopt a causation theory; (5) *Thomas* was non-precedential; and (6) "public policy favors the 'causation' theory and weighs against the [strict liability] theory given the realities of the life insurance industry," i.e., that policyowners will often lapse their policies intentionally and it is unlikely the California legislature would have wanted to gratuitously benefit those policyowners. *Small*, 2024 WL 5051192, at *9.

Notably, *Small* is a class action case. In applying this holding, the same panel also reversed the district court's certification of the class. The district court had adopted the strict liability theory and certified two subclasses: one of beneficiaries suing for the death benefits after the death of the insureds under Rule 23(b)(3), and one of policyowners suing for reinstatement of policies on living insureds under Rule 23(b)(2). Since each class member must prove causation based on their own individual circumstances, the *Small* court held that certification under Rule 23(b)(3) was inappropriate because individual questions would predominate over common ones, and it would be superior to adjudicate such cases on an individual basis. Certification under Rule 23(b)(2) was also inappropriate because (1) it would be inappropriate to force reinstatement on policyowners who cannot opt out, and (2) any declaratory relief, such as that the insurer violated the statutes, would not be useful because class members would still have to prove causation to resolve their claims. The panel also found that the plaintiff is not a typical or adequate class representative because (1) as a beneficiary of an insured who had died, she cannot represent the subclass of living insured policyowners, and (2) as a plaintiff alleging inadvertent lapse, she cannot represent those policyowners who intentionally allowed their policies to lapse.

The plaintiff in *Small* may attempt to obtain a rehearing *en banc*. While there is no dissent in the opinion, it does expressly reject the reasoned decision of the prior panel in *Thomas*. In addition, the possibility remains that the California Supreme Court could disagree with *Small* in a future decision. Nevertheless, the current crop of pending class actions against insurers are likely to be defeated. Given the nature of life insurance, we can still expect a number of individual cases to move forward, but their aggregate liability will likely be far less for insurers.