

**INSURANCE AGENT PERSPECTIVE ON
VARIABLE INSURANCE PRODUCT SUITABILITY**

Friday, August 8, 2008

**ABA Tort Trial & Insurance Practice Section
Corporate Counsel Committee
2008 Annual Meeting**

**Judy L. Burnthorn
Deutsch, Kerrigan & Stiles, L.L.P.
755 Magazine Street
New Orleans, Louisiana 70130
Telephone: (504) 581-5141**

Introduction

Variable annuity suitability from the insurance agent's perspective is a double-edged sword. While unscrupulous agents dominate publicity and reported case law, many conscientious insurance agents and registered representatives diligently try to assess their customers' needs and supply suitable products to meet those needs. Many such agents hold true enthusiasm for their products and expect the market to produce new innovative products that combine investments and insurance.

Variable annuities provide advantageous commission schedules on the "front-end," but overall, the insurance agent may actually reap more profit from placing a customer in a mutual fund. With mutual funds, the agent's perspective is that the client's holding period may be shorter than the holding period for variable annuities, producing the potential for more frequent reinvestment and additional commissions. In some instances, the registered representative may also receive compensation both on the client's entry into and exit from non-insurance types of investments.

The insurance agent marketing variable annuities knows that if there is litigation, the expense and performance of the product which he sells will be compared to equity investments, mutual funds, and other vehicles. Yet in selling his insurance products, he knows not to compare prospectively an insurance contract to stocks, mutual funds, and other investments as part of his sales presentation.

The good insurance agent wants to explain the products he sells in a way that the client understands. Yet, he does not scribble any clarification on sales literature which has been approved by his broker-dealer, and he dare not pull out a yellow tablet to write additional details.

Suitability may arise for the insurance agent in many contexts. To the extent the Securities Act of 1933 applies, it holds rules for the manner in which securities are sold. It contains express

enforcement provisions which may provide the vehicle for a client, disgruntled about his purchase, to complain. Suitability complaints are even more likely to be raised through implied private actions under the Securities Exchange Act of 1934. Suitability issues may arise in other contexts, including class actions, self-regulatory organization arbitrations, enforcement actions, actions against the agent's broker-dealer or in the day-to-day compliance process through which the agent proceeds as a registered representative of a broker-dealer.

This paper explores suitability from the insurance agent's perspective.

Variable Product Litigation

Defense counsel will at some stage in a proceeding brought by the purchaser of a variable product refer to the name of the product – “*variable annuity*” or “*variable life insurance policy*,” to illustrate that the plaintiff who is complaining about his purchase certainly should have known the benefits under the product would *vary*. Tergesen, “The Downside of Market-Proof Annuities, Business Week January 28, 2008. The essence of variable products is that their benefits vary in some fashion with the market during the deferral phase.¹

Fixed annuities give the buyer a minimum fixed rate of return during the deferral period. Professor Bajtelsmit: Good and Bad of Variable Annuities, April 15, 2008, U.S. Federal News. Fixed annuities usually guarantee a minimum fixed rate of interest and promise that the contract value will never fall below the original premiums paid.

¹ Indexed annuities have guaranteed minimum interest rates with returns accruing to the annuitant based on results of a particular market index. Index annuities have different and varying features. Benefits available under *index* annuities typically *vary* based on a market index such as the Dow Jones Industrial Average or the Standard & Poors Composite Stock Index.

Originally, variable annuities accumulated premiums according to values of specific mutual funds purchased in separate accounts, generally without guaranteeing that contract value will remain equal to or greater than premiums invested. As time passed, however, variable annuity issuers innovated with various guarantees and methods of locking in market appreciation. The bright line distinguishing fixed annuities from variable annuities has blurred. Currently there are a wide array of variable annuities on the market which carry with them some of the features of fixed annuities. The new variable annuities have divergent vesting schedules or insurance qualities. At the most basic level, some variable annuities have riders which under certain circumstances, guarantee that benefits paid will never fall below premiums paid.

The nature of variable annuities as *variable* products produces layers of regulation and self-regulatory organization scrutiny not found with respect to their predecessor fixed annuities. The original non-variable insurance products were not regulated as “securities,” but rather as insurance products. *Paul v. Virginia*, 75 U.S. (8 Wall.) 168 (1868) (insurance is a matter not for federal regulation but rather for regulation by the states); §3(a)(8) of the Securities Act of 1933.

Application Of The Securities Act Of 1933 To Variable Insurance Products – Variable Products As “Securities”

Allegations about the suitability of a product for a particular customer may be raised in an action under the express provisions of the Securities Act of 1933. The route to application of express 1933 Act provisions is different for variable insurance products than it is for traditional stocks.

Under Section 2(a)(1) of the Securities Act of 1933, “security” includes “any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, . . . or investment contract.” The “investment contract”

prong of this definition has received particular attention, and the test for determining whether a product is an “investment contract” for purposes of the Securities Act of 1933 was established by the United States Supreme Court in *SEC v. W.J. Howey Company*, 328 U.S. 293 (1946). The Court defined security as “a contract, transaction, or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interest in the fiscal assets employed in the enterprise.” *Id.*

Many insurance products would fall within the Section 2(a)(1) definition. However, Section 3(a)(8) of the 1933 Act, provides an exemption for certain insurance products. The exemption provided by Section 3(a)(8) of the Securities Act of 1933 includes “any insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the Insurance Commission, bank commissioner, or any agency or officer performing like functions, of any state or territory of the United States or the District of Columbia.” Section 3(a)(8) excludes the insurance products which it covers from both the registration and anti-fraud provisions of the 1933 Act. *Tcherepnin v. Knight*, 389 U.S. 332, 342 n.30 (1967); Definition of Annuity Contract or Optional Annuity Contract,” Securities Act Release No. 6558, 1984 SEC LEXIS 258, (Nov. 21, 1984). The SEC stated that:

In the Commission’s view, there can be no serious question that Congress intended any insurance contract (including any annuity contract or optional annuity contract) falling within Section 3(a)(8) of the [Securities Act of 1933] to be excluded from all provisions of the [Securities Act of 1933], notwithstanding the plain language of the Act that Section 3(a)(8) is an ‘exemption’ from the registration but not the anti-fraud provisions. . . .

The United States Supreme Court defined the scope of the Section 3(a)(8) exemption through its decision in *SEC v. VALIC*, 359 U.S. 65 (1959)² and its later decision in *SEC v. United Benefit Life Insurance*, 387 U.S. 202 (1967). The Court focused on three main factors in concluding that variable annuities fell outside the Section 3(a)(8) exemption of the 1933 Act:

1. Investment risks assumed by a purchaser as compared to those retained by the issuer;
2. The way in which the product is marketed; and
3. The mortality risk assumed by the issuer.

Based on the United States Supreme Court's *VALIC* and *United Benefit Life Insurance* decisions, certain products issued by insurance companies are not exempt under Section 3(a)(8) of the 1933 Act. SEC Rule 151 provides more certainty in the area. SEC Rule 151 provides a “safe harbor” relating to the exemption contained in Section 3(a)(8). Annuity contracts meeting the requirements of Rule 151 are exempt under Section 3(a)(8). “Definition of Annuity Contract or Optional Annuity Contract,” Securities Act Release No. 6645 May 29, 1986. Annuity contracts which do not meet the requirements of Rule 151 *may* still fall within the 3(a)(8) exemption under applicable statutory and jurisprudential provisions, even though not entitled to “safe harbor” treatment. In addition to its application to annuity products, the SEC in Release 6645 indicated that Rule 151's “safe harbor” could apply to life insurance contracts meeting the provisions of Rule 151. See, e.g., *Olpin v. Ideal National Insurance Company*, 419 F.2d 1250 (10th Cir. 1969) (Section 3(a)(8) applies); *Grainger v. State Security Life Insurance Company*, 547 F.2d 303 (5th Cir. 1977)

² In *SEC v. VALIC*, 359 U.S. 65 (1959), the United States Supreme Court found that an annuity contract was a security subject to regulation under the Securities Act of 1933. See also *SEC v. United Benefits Life Insurance*, 387 U.S. 202 (1967). Simplifying, annuity contracts which require the purchaser to assume investment risk would be regulated as securities.

(exemption applied). For instance, in *Berent v. Kemper Corp.*, 780 F.Supp. 431 (E.D. Mich. 1991) *aff'd* 973 F.2d 1291 (6th Cir. 1992), the Court found that a whole life insurance contract was exempt under a Rule 151 analysis.

In addition to the exemption contained in Section 3(a)(8), some insurance products issued in conjunction with tax qualified retirement plans may be exempt from registration requirements under Section 3(a)(2) of the Securities Act. See, e.g., *Paul v. Virginia*, 75 U.S. (8 Wall.) 168 (1868) (insurance is a matter not for federal regulation but rather for regulation by the states); see also *Prudential Insurance Company v. SEC*, 326 F.2d 383 *cert denied* 377 U.S. (1964) (separate account of annuities subject to regulation under Investment Company Act of 1940). Variable products offered through qualified sponsoring plans under Internal Revenue Code 401(a), 401(k), 403(a), 404(a)(2), 414(d) or 457(b) are exempt from the Securities Act registration requirements under Section 3(a)(2) of the Securities Act. The rationale for this is that the sponsor stands between the variable product and the purchaser, making 1933 Act requirements less vital.

Issuers of variable products which contain insurance benefits may argue that federal securities laws were never intended to regulate disclosure regarding insurance guarantees. *Cooper et al v. Pacific Life Ins. Co., et al*, 2006 WL 5167787 (S.D. Ga. 2006). If the product is held to be within the 3(a)(8) exemption, antifraud provisions of the Securities Act should not be available. Definition of Annuity Contract or Optional Annuity Contract,” Securities Act Release No. 6558, 1984 SEC LEXIS 258, (Nov. 21, 1984)

Express Remedies Under Securities Act of 1933 – Section 11 And Section 12

Under *VALIC*, *United Benefit Life Insurance*, and cases following those decisions, certain products issued by insurance companies are "securities" subject to the provisions of the Securities Act of 1933. The insurance agent selling variable products may be faced with litigation under the express provisions of the Securities Act of 1933; however, judicial interpretations of the scope of those provisions make their use against insurance agent producers less likely now than in past years.

Section 11 of the Securities Act of 1933 provides an express remedy in favor of the purchaser of a registered security to the extent the purchaser can trace his purchase to shares marketed through a false or misleading registration statement. Section 11 is not frequently used in lawsuits against individual producers but may well be available in litigation against the issuer of variable annuities. This is because the Section 11 remedy only lies against certain specified classes of persons associated with the registration statement. Section 11 provides:

(a) Persons possessing cause of action; persons liable

In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue—

(1) every person who signed the registration statement;

(2) every person who was a director of (or person performing similar functions) or partner in the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted;

(3) every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner;

(4) every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him;

(5) every underwriter with respect to such security.

If such person acquired the security after the issuer has made generally available to its security holders an earning statement covering a period of at least twelve months beginning after the effective date of the registration statement, then the right of recovery under this subsection shall be conditioned on proof that such person acquired the security relying upon such untrue statement in the registration statement or relying upon the registration statement and not knowing of such omission, but such reliance may be established without proof of the reading of the registration statement by such person.

Section 12(1), another express remedy contained in the Securities Act, grants a cause of action to purchasers of securities sold in violation of the registration provisions of the 1933 Act.

Section 12(a)(2) provides an express action against a person who offers or sells a security through a prospectus or oral communication containing material misrepresentations. Section 12 of the Securities Act of 1933 provides:

(A) In general

Any person who –

(1) offers or sells a security in violation of section 77e- of this title, or

(2) offers or sells a security (whether or not exempted by the provisions of section 77c of this title, other than paragraphs (2) and (14) of subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, or such untruth or omission,

shall be liable, subject to subsection (b) of this section, to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

Section 12(a)(2) does not require scienter. It further does not require reliance. In defense of a Section 12(a)(2) action, the defendant may assert (a) truth; (b) lack of materiality; or (c) the statutory defense that he or she “did not know, and in the exercise of reasonable care could not have known, of the untruth or omission.”

In *Gustafson v. Alloyd Company*, 114 S.Ct. 1215 (1994), the United States Supreme Court indicated that Section 12(a)(2) does not apply to securities acquired in the secondary market apart from the initial distribution..

Materiality

Even though defenses under Sections 11 and 12 are limited, and the variable annuity purchaser who sues under those sections need prove fewer elements than a plaintiff under Rule 10(b)(5), like the defendant in a claim under Rule 10(b)(5), the defendant in an action brought under

Sections 11 or 12 of the Securities Act may escape liability altogether if the omission or representation about which the purchaser complains is immaterial. The 1933 Act requires the issuer to fully disclose *material* information. With respect to variable products, that information probably will not include a comparison of the qualified variable product to other non-qualified products or other qualified variable products. *In Re Donald Trump Casino Securities Litigation*, 7 F.3d 357 (3rd Cir. 1993) (“The federal securities laws do not ordain that the issuer of a security compare itself in myriad ways to its competitors, whether favorably or unfavorably, . . .”).

The Court in *In Re Donald Trump Casino Securities Litigation*, 7 F.3d 357, 375-76 (3rd Cir. 1993), stated:

The federal securities laws do not ordain that the issuer of a security compare itself in myriad ways to its competitors, whether favorably or unfavorably, for at least three reasons. First, such a requirement would impose an onerous if not unsurmountable obstacle on issuers of securities to ensure they obtain accurate information on all aspects of their competitors which a reasonable investor might find material. Second, were we to announce such a requirement, the likely result would be to inundate the investor with what the Supreme Court disparaged as ‘an avalanche of trivial information.’ Third – and of great consequence – it is precisely and uniquely the function of the prudent investor, not the issuer of securities, to make such comparisons among investments.

In *Donovan v. American Skandia Life Assurance Corp.*, 2003 WL 21757260 (S.D. N.Y. July 31, 2003), the court dismissed a class action alleging that variable annuities were unsuitable for purposes of funding qualified retirement plans, in the absence of an express warning in the prospectus that it is “unnecessary” to fund a qualified plan with a deferred annuity. The court found that NASD Notice to Members 99-35 and its provisions applies only to registered representatives selling annuities, not to the annuity issuer in the prospectus. The court further held that omission

of the warning suggested by the plaintiffs was not a *material* misrepresentation in connection with the annuity prospectus³

The decision of the Court in *Johnson v. Aegon U.S.A., Inc.*, 355 F.Supp.2d 1337, 1340 (N.D. Ga. 2004) is seemingly at odds with *Donovan* to the extent that the motion to dismiss of the insurer, under circumstances similar to those present in *Donovan*, was denied. The court found that it could not conclude as a matter of law that the prospectus contained was free of misrepresentations or omissions. In *Johnson v. Aegon USA, Inc.*, 355 F.Supp.2d 1337 (N.D. Ga. 2004), the plaintiffs sued under Sections 11 and 12 of the Securities Act of 1933 alleging that the defendants illegally failed “to reveal that these deferred annuities were not generally appropriate investments for placement into qualified retirement plans.” 355 F.Supp. at 1340. The Court refused to grant defendants’ motion to dismiss on grounds including the duty to disclose and materiality.⁴

³ In *Donovan v. American Skandia Life Assurance Corp.*, 2003 WL 21757260 (S.D. N.Y. 2003), the Court held that the omitted information was not required to be disclosed in the prospectus. The Court did not rule out the possibility that (based on NASD Notice to Members 99-35) registered representatives may need to make such disclosures to investors. The Notice to Members, however, did not apply to annuity issuers, and the prospectus itself did advise that professional tax advice should be obtained.

⁴ There is also an express private right of action under §29(b) of the Securities Exchange Act. *Freeman v. Marine Midland Bank-New York*, 1979 U.S. Dist. LEXIS 12177 at *5-6 (E.D. N.Y. 1979) (“the court is not being asked to imply a private right of action for damages. . . . courts have held that §29(b) provides a plaintiff with an independent and express statutory right to relief.” §29(b) makes the contract “merely voidable at the option of the innocent party.” *Mills v. Elec. Auto-Light Company*, 396 U.S. 375, 387 (1970).

§29(b) of the Securities Exchange Act permits court to order rescission of contracts made in violation of Securities Exchange Act provisions, under certain circumstances. §29(b) of the Securities & Exchange Act is an equitable remedy, and therefore, equitable doctrines such as laches apply when it is invoked. In order to obtain rescission under §29(b), the investor may only obtain relief when he acts promptly and with due diligence to obtain the remedy. For instance, in *In Re National Student Marketing Litigation*, 445 F. Supp. 157, 163 (D.D.C. 1978), the court held that the plaintiffs failed to act with sufficient haste to obtain rescission.

Courts have held that information on the ultimate use to which the variable annuity issuer puts expenses and charges, after they are paid by the investor, is not material information. *In Re Morgan Stanley and Dan Van Kampen Mutual Fund Securities Litigation*, 2006 WL 1008138 at *9 (S.D. N.Y. April 2006); *In Re Merrill Lynch Investment Management Fund Securities Litigation*, 434 F. Supp. 2d 233, 238 (S.D. N.Y. 2006). (“Defendants disclosed the fees and commissions charged to shareholders. The precise allocation of those fees is not material information under the securities laws.”). If the qualified variable product discloses the total cost, it may not be material that part of the fees being charged pay for a tax deferral premium.

The Securities Exchange Act Of 1934 – Implied Remedies Including Rule 10(b)(5)

The plaintiff in an action under Rule 10(b)(5) must show six elements:

- (1) A material misrepresentation or omission;
- (2) Scienter;
- (3) "In connection with" the purchase or sale of a security;
- (4) Reliance;
- (5) Economic loss; and
- (6) Loss causation.

See *e.g. Mississippi Public Employees’ Retirement System v. Boston Scientific Corporation*, 523 F.3d 75 (1st Cir. 2008); see also *Dura Pharm, Inc. v. Broudo*, 544 U.S. 336, 341-342 (2005).

A claim under §29(b) of the Securities Exchange Act does not require that the plaintiff establish reliance and causation. *Berkeley Investment Group, Ltd. v. Colkitt*, 455 F.3d 195, 208 (3d Cir. 2006) (an action under §29(b) “differs from a private damages action brought under §10(b)” to extent that the plaintiff in a §29(b) action “does not have to establish reliance and causation”).

Reliance

Rule 10(b)(5) is a frequently used tool of disgruntled variable products purchasers. Although the elements of a 10(b)(5) case require reliance, the reliance requirement may, under certain circumstances, be satisfied with a presumption articulated by the United States Supreme Court in *Affiliated Ute Citizens of Utah v. U.S.*, 406 U.S. 128 (1972).

There is authority, however, that the *Affiliated Ute* presumption does not apply to all omissions across-the-board. In some instances, where the omission is one which allegedly is needed to make other disclosed information not misleading, the *Affiliated Ute* presumption may not be available. *Wilson v. Comtech Telecommunications Corp.*, 648 F.2d 88 (2nd Cir. 1981); *Feinman v. Dean Witter Rentals, Inc.*, 84 F.3d 539 (2nd Cir. 1996). In *Wilson*, the Court stated:

[The defendant's] statements were reasonable and were believed to be true when made. However, they later became misleading, if treated as current, when the company failed to disclose the new information . . . to characterize this, for purposes of establishing reliance, as either an omission or a misrepresentation case is to beg the question. In many instances, an omission to state a material fact relates back to an earlier statement, and if it is reasonable to think that that prior statement still stands, then the omission may also be termed a misrepresentation. The labels by themselves, therefore, are of little help. What is important is to understand the rationale for a presumption of causation in fact in cases like *Affiliated Ute* in which no positive statements exist: reliance as a practical matter is impossible to prove, the situation here does not present that problem.

648 F.2d at 93.

Loss Causation and Damages

The variable annuity purchaser may experience difficulty in proving the Rule 10(b)(5) requirement of loss causation. *Robbins v. Koger Properties, Inc.*, 116 F.3d 1441, 1447 (11th Cir. 1997); *Dura Pharm, Inc. v. Broudo*, 544 U.S. 336, 125 S.Ct. 1627 (2005). Even if the plaintiff shows that the product was not well suited based on his risk tolerance and time horizon, the plaintiff still must show a causal connection to the loss, i.e. to the decline in value of the investment. See, e. g., *Merrill Lynch Investment Management Funds*, 434 F. Supp. 2d at 238 (“The fees charged to shareholders, which were disclosed, do not constitute a loss. . .”).

In addition to problems proving *causation* of the loss, the variable annuity purchaser may have difficulty proving that he has suffered any compensable loss at all. For instance, it may be impossible for purchasers to prove that the tax shelter or insurance features of qualified variable products are the cause of any greater expense or premium relating to the variable products. *Cooper, et al v. Pacific Life Ins. Co., et al*, 2006 WL 5167787 (S.D. Ga. 2006). The issuer of the qualified variable product may make no expense charge that is specifically linked to the tax deferred status of the product. The expense of the tax shelter features may not be evident from sales literature or other available documentation and may require expert analysis.

The federal securities laws allow victims of fraud, to recover their “‘actual loss’—the difference between what they paid for the stock and what it was worth.” *Astor Chauffeured Limousine Co. v. Runnfeldt Investment Corporation*, 910 F.2d 1540, 1551 (7th Cir. 1990) citing *Pelletier v. Stuart-James Co., Inc.*, 863 F.2d 1550, 1557-58 (11th Cir. 1989); *Feldman v. Pioneer Petroleum, Inc.*, 813 F.2d 296, 301-02 (10th Cir. 1987). Generally, the maximum recovery in the case of fraud influencing a purchase is the purchase price, a limit §§11 and 12 of the 1933 Act make

explicit, and that § 28 of the 1934 Act strongly implies. *Astor*, 910 F.2d at 1551. Under both the 1933 and 1934 Acts, the statutes limit victims to “actual damages,” which the courts frequently understand to mean “out of pocket loss.” *Id.* citing *Levine v. Seilon, Inc.*, 439 F.2d 328 (2d Cir. 1971) (Friendly, J.); *Harris v. American Investment Co.*, 523 F.2d 220, 224-27 (8th Cir. 1975) (collecting case).

To successfully maintain an action under either of the federal securities acts, a party must prove damages as a result of the complained of acts. *See Commercial Union Assurance Co. v. Milken*, 17 F.3d 608, 613-16 (2d Cir. 1994). In *Commercial Union*, a group of investors brought suit against a stock speculator, the vice-president of a bond department assisting the speculator in the reorganization of his partnership, and one of the vice-president’s employees. The suit was filed under § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1988), and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5 (1993); and § 12(2) of the Securities Act of 1933, 15 U.S.C. § 77i(2) (1988). Based upon the plaintiff’s alleged failure to assert all necessary elements in a securities fraud claim, the defendants moved for summary judgment asserting that the plaintiffs failed to establish that the defendants were statutory sellers as required under § 12(2). The district court granted the defendant’s summary judgment and the appellate court affirmed, but based its decision on other grounds.

The appellate court affirmed the summary judgment based upon its own finding that the plaintiffs had not successfully established any damages under their claims. The court reasoned that after computing the plaintiff’s total damages offset by their recovery from third party settlements and distributions, the net result was that the plaintiffs had not suffered compensable damages. The court specifically noted: “while we have no difficulty in finding that plaintiff’s causes of action might well

subject defendants to liability, plaintiffs can prove no damages.” *Id.* at 609. Accordingly, “had appellants suffered compensable damages, their cause of action...would have been sufficient to withstand a motion for summary judgment.” *Id.* at 616. Allowing the plaintiffs to maintain a cause of action, under such circumstances, would constitute a “waste of judicial resources.” *Id.* at 616; *See* H.R.Rep. No. 85, 73d Cong., 1st Sess. 9 (1933)(under §12 the buyer can “sue for recovery of his purchase price, or for damages not exceeding such price”).

Similarly, in *In re Investors Funding Corp. v. Peat, Marwick, Mitchell & Co.*, 523 F.Supp. 563, 566 (S.D.N.Y. 1980). The Court found the absence of any loss to be an “insurmountable obstacle to his [plaintiff's] claim based on that purchase.” *Id.*

Even if the purchaser of a qualified variable product establishes that the product is unsuitable, he may not be able to recover hypothetical amounts that he would have earned had he invested in a different product. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

Misrepresentation and Suitability

In many 10(b)(5) actions, the variable annuity purchaser alleges that sale of an unsuitable variable annuity constitutes the culpable conduct in violation of Rule 10(b)(5). The buyer also may allege that the producer misrepresented that the variable product was suitable when, in fact, it was not. In the past, Rule 10(b)(5) actions arising from this type of suitability analysis focused on NASD Rule 2310. Section 2310 of the NASD Rules states in pertinent part that, “[i]n recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs. . . .”(emphasis supplied). The Rule further states that "prior to the execution of a

transaction *recommended* to a non-institutional customer, ...a member shall make reasonable efforts to obtain information concerning: (1) the customer's financial status; (2) the customer's tax status; (3) the customer's investment objectives; and (4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer. NASD Rule 2310(b)(emphasis supplied).

The NASD has stated that Rule 2310 relating to suitability applies not only to the sale of variable annuities but also to recommendations that variable annuities be surrendered. It stated that Rule 2310 “applies to any recommendation to sell a variable annuity regardless of the use of proceeds Any recommendation to sell the variable annuity must be based upon the financial situation, objectives and needs of the particular investor.” Regulatory & Compliance Alert (Spring 2002) at 13. See also NASD Notice to Members 05-50 (August 2005) (“Recommendations to . . . surrender a . . . variable annuity. . . . must be suitable . . .”).

Through Notices to Members and other statements, the NASD and the SEC have detailed and clarified application of this general suitability rule to variable products. In 1996, the NASD issued Notice to Members 96-86 reminding members and registered representatives that they needed to have reasonable grounds on which to believe that variable annuity sales are suitable. NASD’s Notice To Members 99-35 provides guidelines for determining suitability of variable annuities and indicates that variable annuities are long-term investments.⁵ The NASD has further cautioned that the time horizon of the variable annuity purchaser should be fairly long, stating: “FINRA has repeated that **variable annuities** are generally considered to be long-term investments and are

⁵ NASD Notice to Members 00-44 issued in 2002 provides guidelines for the suitability analysis required of members in connection with the sale of variable life insurance products.

therefore typically not **suitable** for investors who have short-term investment horizons.” NASD Notice to Members 07-43 at page 4 (emphasis supplied). NASD/FINRA has also expressed concern about over-reliance on net worth in evaluating suitability, especially when the net worth consists virtually exclusively of the purchaser's home. The NASD stated: " we also caution firms that customer's net worth alone is not determinative of whether a particular product is suitable for that investor, even when the investor qualifies as an accredited investor under Regulation D of the Securities Act of 1933. Over-reliance on net worth is particularly problematic where an investor meets the accredited investor standard based largely on home values, which may represent the largest asset of many senior investors. . . . Simply put, eligibility does not equal suitability.” *National Association of Securities Dealers* Notice to Members 07-43 September 3, 2007 at page 4. FINRA has expressed concern over situations in which variable annuities are marketed to senior citizens who may have diminished capacity; FINRA suggested steps which could be used in such situations.⁶

⁶ **Diminished capacity and suspected financial abuse of seniors.** . . . “In addition to the regulatory concerns discussed above, there are other issues that firms sometimes encounter when dealing with senior investors. One of the most troubling to the firms we surveyed is that of investors who exhibit signs of diminished mental capacity. . . . These sensitive issues were raised repeatedly by firms we surveyed for this notice, and we include in this Notice, for the consideration of other FINRA members, some of the steps that firms, as a matter of sound business practice and as a way of serving their senior customers, are taking to address them. . . . These steps include:

- Designating a specific individual or department, such as the compliance or legal department, to serve as a central advisory contact for questions about senior issues, as well as a repository of available resources.

- Providing written guidance to employees on senior-related issues, such as how to identify and/or what to do if they suspect their customer is experiencing diminished capacity or is being abused, financially or otherwise, by a family member, caregiver, or other third party. . . .

Apparently considering that this gloss placed on Rule 2310 was insufficient, the NASD and the SEC recently approved a new Rule, Rule 2821, relating to suitability of variable annuities. Section (b) of the Rule contains specific requirements regarding suitability. It provides:

(b) Recommendation Requirements –

- (1) No member or person associated with a member shall recommend to any customer the purchase, sale or exchange of a deferred variable annuity unless such member or person associated with a member has a reasonable basis to believe that
 - (A) the customer has been informed of the material features of the deferred variable annuity,

-
- Asking either at account opening or at a later point, whether the customer has executed a durable Power of Attorney. . . .
 - Asking, either at account opening or at a later time, whether the customer would like to designate a secondary or emergency contact for the account whom the firm could contact if it could not contact the customer or had concerns about the customer's whereabouts or health. . . .
 - Asking the customer if he or she would like to invite a friend or family member to accompany the customer to appointments at the firm.
 - Informing the customer (where appropriate) that, in the firm's view, a particular unsolicited trade is not suitable for the customer.
 - Reminding registered representatives that it is important when dealing with customers, particularly seniors, to base recommendations on current information.
 - Offering training to help registered representatives understand and meet the needs of older investors, including proper asset allocation, liquidity demand, and longevity needs, as well as the possible changes in their suitability profiles. . . .

National Association of Securities Dealers, Inc. Notice to Members Regulatory Notice 07-43
September 10, 2007 at 6-7.

- (B) the customer has a long-term investment objective, and
 - (C) the deferred variable annuity as a whole and the underlying sub-accounts are suitable for the particular customer based on the information required by paragraph (b)(2) of this Rule. These determinations shall be documented and signed by the associated person recommending the transaction, in addition to being approved by a registered principal, as required by paragraph ©) of this Rule.
- (2) Prior to recommending a deferred variable annuity, a member or person associated with a member shall make reasonable efforts to obtain, at a minimum, information concerning the customer's age, annual income, financial situation and needs, investment experience, investment objectives, intended use of the contract, investment time horizon, existing investment and insurance holdings, liquidity needs, liquid net worth, risk tolerance, tax status and such other information used or considered to be reasonable by the member or person associated with the member in making recommendations to customers." NASD Rule 2821(b).

Rule 2821 also contains new, expanded review and approval provisions, supervisory provisions, and training provisions. Sections ©), (d), and (e) of Rule 2821 provide:

(c) Principal review and approval

- (1) No later than two business days following the date when a member or person associated with a member transmits a customer's application for a deferred variable annuity contract to the issuing insurance company for processing, a registered principal shall review and approve the transaction, regardless of whether the transaction has been recommended. In reviewing the transaction, the registered principal shall consider whether
 - (A) the customer appears to have a demonstrable need for the features of a deferred variable annuity as compared with other investment vehicles;
 - (B) the customer's age or liquidity needs make a long-term investment inappropriate, such as a customer over a specified age (standard established by the member) or with a short-term investment objective;
 - (C) the amount of money invested exceeds a stated percentage of the customer's net worth or is more than a stated dollar amount (standards established by the member);
 - (D) the transaction involves an exchange or replacement of a deferred variable annuity contract; and

- (E) the deferred variable annuity transaction involves a customer whose account has a particularly high rate of deferred variable annuity exchanges or replacements. Standards established by the member must be reasonably designed to ensure that transactions in deferred variable annuities are appropriately supervised.
- (2) When a member or a person associated with a member has recommended the transaction, a registered principal, taking into account the underlying supporting documentation described in paragraph (b)(2) of this Rule, shall review, approve and sign the suitability determination document required by paragraph (b)(1) of this Rule no later than two business days following the date when the member or person associated with the member transmits the customer's application for a deferred variable annuity contract to the issuing insurance company for processing..
- (d) Supervisory Procedures – In addition to the general supervisory and record keeping requirements of Rules 3010, 3012 and 3110, a member must establish and maintain specific written supervisory procedures reasonably designed to achieve compliance with the standards set forth in this Rule. In particular, the member must implement procedures to screen for and require a registered principal's review of the following:
- (1) a deferred variable annuity investment for a customer who does not appear to have a demonstrable need for the features of a deferred variable annuity as compared with other investment vehicles;
 - (2) a deferred variable annuity investment for a customer whose age or liquidity needs may make a long-term investment inappropriate, such as any customer over a specified age (standard established by the member) or with a short-term investment objective;
 - (3) a deferred variable annuity investment exceeds a stated percentage of the customer's net worth or is more than a stated dollar amount (standards established by the member);
 - (4) a deferred variable annuity exchange or replacement;
 - (5) a deferred variable annuity investment for a customer whose account has a particularly high rate of deferred variable annuity exchanges or replacement; and
 - (6) a deferred variable annuity transaction where the associated person effecting the transaction has a particularly high rate of effecting deferred variable annuity exchanges or replacements. Standards established by the member must be reasonably designed to ensure that transactions in deferred variable annuities are appropriately supervised.”

(e) Training – Members shall develop and document specific training policies or programs designed to ensure that associated persons who effect and register principals who review transactions in deferred variable annuities comply with the requirements of this rule and that they understand the material features of deferred variable annuities, including liquidity issues, sales charges, fees, and market risks. . . .

The American Council of Life Insurers objected to Rule 2821 in comments provided to the SEC. A.M. Best Newswire, “Life Insurers Protest Suitability Rule For Deferred Variable Annuity Sales,” September 23, 2005. It contended that by creating “single-product supervision,” Rule 2821 “may actually thwart effective system-wide uniformity and compliance.” A.M. Best Newswire, “Life Insurers Protest Suitability Rule For Deferred Variable Annuity Sales,” September 23, 2005. (Quoting September 19, 2005 letter from Carl Wilkerson, Vice President and Chief Counsel of The American Council of Life Insurers to the SEC). The American Council of Life Insurers asserted that the SEC fielded 14 times as many equity security complaints as complaints about variable annuities. A.M. Best Newswire, “Life Insurers Protest Suitability Rule For Deferred Variable Annuity Sales,” September 23, 2005. It further stated that the SEC received 4.5 times as many complaints about mutual funds as about variable annuities. A.M. Best Newswire, “Life Insurers Protest Suitability Rule For Deferred Variable Annuity Sales,” September 23, 2005.

The NASD did not abandon the Rule as a result of this and other comments, but it did change the rule in response to public comments. The following are changes which the NASD adopted in response to public comment:

- (a) “NASD created a broad exemption for certain transactions made in connection with tax-qualified employer sponsored retirement or benefit plans. . . .” August 31, 2006 letter from James S. Wrona, Associate Vice President and Associate General

Counsel NASD, to Nancy M. Morris, Secretary Securities & Exchange Commission (“Wrona August 31, 2006”) at page 5.

- (b) “NASD eliminated the requirement that firms provide a written, product-specific disclosure, which some commentators argued would have been too costly and burdensome.” *Wrona* August 31, 2006 at page 5, n. 8.

The NASD also specifically addressed commentators concerns about early principal review stating:

The requirement that a principal review deferred variable annuity transactions at the early stages of the process not only is necessary for the protection of investors, but it also should promote efficiency (e.g. problems will be caught early and fewer transactions will have to be unwound). In addition, NASD indicated in its rule filing that firms could use automated supervisory systems, under certain circumstances, to increase efficiency while insuring investor protection.” *Wrona* August 31, 2006 at page 5, n. 8.

Secondary Liability Issues Relating To Suitability

On its face, the rule applies to member broker-dealers selling variable annuities but not to nonmember issuers. In many cases, the wholesale issuer of the variable product makes no recommendation to the customer. In some instances, the issuer is not an NASD member. The NASD addressed this situation, stating “[o]ne commentor asked whether Rule 2821 applies to an issuer’s direct sale of a deferred variable annuity to a customer without any involvement of a broker-dealer or persons associated with a broker-dealer. FINRA’S rules apply only to member broker-dealers and their associated persons. FINRA notes, however, that the determination of whether an entity should be registered as a broker-dealer rests with the SEC.” NASD Notice to Members Notice 07-53 at n. 23.

Such issuers of variable products take the position that they have no duty to perform or oversee suitability determinations of retail broker dealers. See *Price v. Countrywide Home Loans, Inc.*, 2005 WL 235438 at *7 (S.D. Ga. 2005); *Chevron U.S.A., Inc. v. Natural Resources Defense Counsel, Inc.*, 467 U.S. 837, 104 S. Ct. 2778 (1984); *City of Bella Rica v. Couch*, 281 F.2d 284 (5th Cir. 1960). There is contrary authority indicating that while NASD's general suitability Rule and new Rule 2821 are not, on their face, applicable to non-member issuers, such issuers may still have liability for improper sales practices. In a 1979 release, the SEC stated that “[i]t is the issuer’s responsibility to supervise distributors and to see that its contracts are offered and sold in a responsible manner.” *SEC Securities Act Release No. 6051, 1979 SEC LEXIS 1827 (Apr. 5, 1979)*. Release 6051 was withdrawn in connection with the promulgation of Rule 151.⁷ However, in 1986, the SEC promulgated a release which may have resurrected certain portions of Release 6051. In 1986, the SEC stated, “The Commission, however, reiterates the position it took in footnote 13 of Release 6051.” *SEC Securities Act Release No. 6051, 1986 SEC LEXIS 1451 (May 29, 1986)*.

The Court in *Brooks v. Lincoln National Life Insurance Company*, 2008 WL 623222 (E.D. Tex. Mar. 5, 2008), refused to grant summary judgment in favor of the insurer/issuer based on the allegation that the producer who sold the variable annuity allegedly failed to disclose that its tax benefits were redundant; the annuity was purchased in an IRA. The producer also allegedly failed to adequately assess suitability. The Court did not make any explicit finding that made clear whether either co-defendant was a NASD member broker-dealer to which SRO suitability and supervision rules applied. Even without such a conclusion, the court made several statements indicating the

⁷Rule 151 provides a safe harbor for certain qualifying transactions in order to ensure the exemption from registration contained in Securities Act Section 3(a)(8).

potential that defendant Lincoln National should have done more to supervise or control the producer. The Court stated:

Lincoln cannot relieve its duty to inform investors of these matters to its broker-dealers or to another company such as New York Life. Lincoln admits in its broker-dealer selling agreements with representatives like David Adams that Lincoln ‘shall be liable for all statements contained in the current prospectus.’ . . . Lincoln permits representatives like David Adams to use sale materials either provided directly by Lincoln or pre-approved by Lincoln. . . .

* * *

Again, considering Brooks’ agency and control person theories of liability, the Court finds there is a duty to conduct suitability reviews. Again, the Court finds any failure by Lincoln to conduct its own suitability analysis of Brooks’ application cannot be relieved by any action of New York Life. Genuine issues of material fact exist as to whether Lincoln conducted suitability reviews or whether Lincoln’s agents did so.

2008 WL 623222 at *14.

However, the Court did not overtly base its holding on either control personal liability or failure to supervise according to NASD rules. Instead, the Court articulated a pure agency theory.

2008 WL 623222 at *11. The Court stated:

Brooks’ allegations that Adams acted as defendants’ agent in recommending the variable annuity to plaintiffs, which must be taken as true for all purposes at this stage, are sufficient facts that could establish a duty to disclose under the Exchange Act.

2008 WL 623222 at *11.

The Court in *Delaney v. American Express*, 2007 WL 1420766 (D.N.J. May 11, 2007), while not totally absolving the nonmember issuer from any supervision responsibility for broker-dealer sales practices, did require more than a mere agency relationship. The court indicated that plaintiffs’

negligent supervision or training claims required not merely an agency relationship but rather an employment relationship between the producer and the defendant. 2007 WL 1420766 at *6. One of the Court's grounds of dismissal was based on the fact that the plaintiff alleged only an agency relationship stating that the producers "were agents of AEL and AMEX because Defendants authorized them to act on Defendants' behalf in explaining and selling the annuities." 2007 WL 1420766 at *7.

Both issuers and broker dealer's may face issues beyond the potential applicability of broker-dealer type responsibility for producer conduct.⁸ Federal (and many state) securities laws provide express provisions which render certain controlling persons liable for the conduct of their representatives.⁹ *CEG G.A. Thompson & Company, Inc. v. Partridge*, 636 F.2d 945 (5th Cir. 1981); *Paul F. Newton & Company v. Texas Commerce Bank*, 630 F.2d 1111, 1119 (5th Cir. 1980). Most courts have held that these express liability provisions in no way alter the traditional liability of the

⁸ NASD Rule 3010 sets forth the broker dealer's general duties relating to supervision. The rule does not apply to non-member issuers.

⁹ Section 20 of the Securities Exchange Act of 1934 provides:
§78t. Liability of controlling persons and persons who aid and abet violations

(a) Joint and several liability; good faith defense

Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

The comparable Securities Act provision is found in Section 15

employer for acts of the employee committed within the course and scope of employment.¹⁰ Therefore, even if a defendant establishes that under controlling person statutes, it is entitled to a good faith defense because it properly supervised and had no knowledge of any wrongdoing, the defendant may remain liable for the acts of its employee within the course and scope of employment. The court in *Paul F. Newton & Co v. Texas Commerce Bank*, 630 F.2d 1111, 1118 (5th Cir. 1980), explained that “to limit secondary liability for violations of the securities acts to the situations encompassed by sections 15 and 20(a) in the employer-employee context, ... would allow an employer who would otherwise be responsible for the acts of its employees to escape liability merely by showing that it acted in good faith and neither had knowledge of nor participated in the unlawful acts.” the Paul F. Newton & co. court concluded that vicarious liability persisted for good faith employers who properly supervised their employees, if the employee committed a tort within the course and scope of employment.

The vicarious liability issue for determination is not whether the broker-dealer had any knowledge about what the registered representative was doing. *Id.* The issue is whether the registered representative was in the course and scope of his employment with the broker-dealer when he solicited the customer to invest. The test for this inquiry was explained by the Court in *Home Life Insurance Company, New York v. Equitable Equipment Company, Inc.* 680 F.2d. 1056 (5th Cir. 1982), an employer was vicariously liable for fraudulent claims made by its employee because the conduct was connected in time and place to his employment. Unbeknownst to the employer,

¹⁰ The United Fifth Circuit Court of Appeals stated in *Paul F. Newton & Company v. Texas Commerce Bank* that “We conclude that Section 20(a) does not supplant or exclude the application of common law principles of agency, in particular the doctrine of respondeat superior, in an action brought under the Securities Exchange Act. . . .” 630 F.2d at 1119.

Equitable, one of its employees submitted a mixture of valid and fraudulent medical insurance claims to Home Life. *Id* at 1058. Home Life acted on all of the claims and, as a result, sustained high losses. The employee was prosecuted for federal crimes and served a prison sentence. Home Life sued Equitable, as well as the employee, to recover the loss. The court used the following four part test to determine that the employee was acting within the scope of employment;

- (1) The tortious act was primarily employment-rooted,
- (2) The act was reasonably incidental to the performance of the employee's duties,
- (3) The act occurred on the employer's premises, and
- (4) It occurred during the hours of employment.

To begin, the court determined that the scheme "was concocted at the job-site, on Equitable's time." Further, the court found the conduct was causally related to employment duties, was not motivated purely for personal reasons, and ultimately, was in the interest of the employer. The court stated, "this is not a case where an employee turned aside from his ordinary duties and responsibilities to perpetrate a crime, rather his actions were carefully contrived to fit into his normal duties in the usual course of events."

The mere fact that an agent's conduct is contrary to his principal's express direction, rules or wishes is not conclusive of the issue of scope of employment. *Poydras v. Parker*, 392 So.2d. 94, 95 (La. App. 1980); *White Auto Stores Inc., v. Reyes* 223 F.2d. 298 (10th Cir. 1955). Relevant questions for the scope of employment inquiry in this context include whether the solicitation occurred on the employer's premises, whether it occurred during hours of the registered representative's employment, whether the solicitation conduct is of the same general nature as the

Variable Annuity Bonus Cases

Several variable annuity cases have been filed with respect to “bonus” provisions of the variable annuity contract. Some such cases allege that investors were misled into believing that they would obtain an immediate bonus when actually, through misrepresentations or omissions in connection with their purchase of the variable annuity, the “bonus” pertained to annuitized value, not cash value. *Castello v. Alliance Life Insurance Company of North America*, No. 03-20405 (Minn. Dist. Ct. Sept. 1, 2005; Jorden, "Class Action Annuity Litigation," ALI-ABA Continuing Legal Education May 10-11, 2007 at *17 *et. seq.*. Similar claims that the “bonus” feature of the annuity was misrepresented have been made in *Mooney v. Alliance Life Insurance Company of North America*, 2007 WL 128841 (D. Minn. 2007). A twist on these cases is a claim by some investors that there was not actually a “bonus” because it was completely recaptured during the life of the annuity. *Phillips v. American International Group, Inc.*, No. 1:07-CD-00802-JSR (S.D. N.Y. Feb. 1, 2007); *Delaney v. American Express Company*, No. CV-06-5134 (D.N.J. 2006); *Smith v. John Hancock*, No. 2:06-CV-03876-MK (E.D. Pa. 2006).

In *Delaney v. American Express Company*, 2007 WL 2933069 (D.N.J. June 6, 2007), plaintiffs complained about inadequate disclosure of “bonus” features of their American Express annuity. They alleged that they were not informed that they “were paid less in subsequent years than they would have been paid had they purchased an annuity without a ‘bonus’ feature, because, plaintiffs alleged, recoupment of the bonus was built into the actuarial pricing model used for the so-called ‘bonus annuity.’” 2007 WL 2933069 at *4. The Court dismissed plaintiffs’ claims on a motion because American Express did disclose that because of the initial bonus, rates in later years would be lower.

Variable Annuities in Qualified Plans

NASD Notice to Members 99-35 states with respect to variable annuities in qualified plans that:

When a registered representative recommends the purchase of a variable annuity for any tax-qualified retirement account (e.g. 401(k) plan, IRA, the registered representative should disclose to the customer that the tax deferred accrual feature is provided by the tax-qualified retirement plan and that the tax-deferred accrual feature of the variable annuity is unnecessary. The registered representative should recommend a variable annuity only when its other benefits, such as lifetime income payments, family protection through the death benefit, and guaranteed fees, support the recommendation.

Many variable annuity suitability cases claim that the variable annuity was unsuitable for the purchaser merely because it was purchased in a qualified retirement plan. For example, in *Brooks v. Lincoln National Life Insurance Company*, 2008 WL 623222 (E.D. Tex. Mar. 5, 2008), the Court denied the insurer's motion for summary judgment as to the plaintiff's claim under Rule 10(b)(5).

Brooks already owned two NYLIC variable annuities before he purchased a variable annuity from defendant Lincoln National. Since Brooks already owned two NYLIC variable annuities, it was questionable whether he needed to purchase a Lincoln National annuity as opposed to making allocation adjustments to his existing annuity. Suitability of the new Lincoln National variable annuity was therefore questionable. Plaintiff Brooks had become dissatisfied with his NYLIC producer and changed to a Lincoln National producer.¹¹ Brooks' NYLIC holdings were going down in value. 2008 WL 623222 at *8. Regarding his meeting with the Lincoln National agent (Mr.

¹¹The Court does not indicate whether any defendant was a member broker-dealer with whom the Lincoln National producer, Adams, was associated. Instead, the Court states only that "Brooks' allegations that Adams acted as defendants' agent in recommending the variable annuity to plaintiffs, which must be taken as true for all purposes at this stage, are sufficient facts that could establish a duty to disclose under the Exchange Act." 2008 WL 623222 at *11.

Adams) plaintiff stated, “Mr. Adams told me that I was investing in all the wrong things, that if he had the account, he would invest in – I don’t ... remember what. . . .” 2008 WL 623222 at *8. The decision indicates that the plaintiff bought the Lincoln National annuity with funds from the second of two NYLIC annuities which he had purchased approximately one year earlier. 2008 WL 623222 at *6. The plaintiff purchased the new Lincoln National annuity in his IRA. He pointed to NASD statements that “When a registered representative recommends the purchase of a variable annuity for any tax-qualified retirement account, the registered representative should disclose to the customer that the tax-deferred accrual feature of the variable annuity is unnecessary.” 2008 WL 623222 at *11. Brooks further alleged that fees on his NYLIC annuity were lower than the new Lincoln National annuity and that he “had no insurance needs.” 2008 WL 623222 at *11. The plaintiff complained that Lincoln National should have assessed suitability; in his deposition, the plaintiff stated, “They are supposed to see if this person really needs this or whatever before they issue that policy. Am I correct?” 2008 WL 623222 at *10.

Brooks apparently did not complain about the successive purchase of variable annuities.

Issues of fact precluding summary judgment existed because the prospectus did not disclose inter alia:

That if a person is purchasing a Lincoln variable annuity with funds from a qualified plan, the Lincoln variable annuity will not provide additional tax benefits....
2008 WL 623222 at *13.

In these types of variable annuity cases, plaintiffs typically contend that the variable annuities are too expensive, with charges being for tax deferral benefits that already exist in the qualified plan. In a class action by variable annuity purchasers against Pacific Life Insurance Company, Pacific Life

Insurance Company submitted an expert report authored by Douglas L. Robbins which minimized the significance of the tax advantages of the variable annuity, stating:

- (1) “Congress has tried quite often to retroactively make gains within non-qualified deferred annuities taxable. Thus, tax deferral could vanish at any time without recourse.” *Cooper v. Pacific Life Insurance Company*, 2006 WL 5146497 (S.D. Ga. Aug. 3, 2006) (expert report of Douglas L. Robbins at *3).
- (2) Tax advantages of variable annuities have decreased in recent years but variable annuity sales continue to grow. *Id.* “This shows that the market has begun to increasingly value other benefits contained in these types of annuities. . . .” *Id.* at *3.

To defend the variable annuity sales in cases like this, issuers contend that the variable annuity is in fact suitable because it contains unique non-tax features, making it a suitable investment in a qualified plan. In *Cooper v. Pacific Life Insurance Company*, 2006 WL 5167798 (S.D. Ga. Oct. 17, 2006), Pacific Life Insurance Company’s expert concluded that the death benefit feature of the variable annuity at issue had a value of \$1,418 per \$100,000 invested. *Id.* at *6. Pacific Life’s expert opined that the death benefit had significant value.

Non-tax aspects of variable annuities which defendants emphasize in these types of suitability cases include living benefits of various types, including the following:

“Guaranteed Lifetime Withdrawal Benefit – This benefit guarantees income for life by allowing fixed withdrawals (typically 4-5% of the annuity premiums) for as long as the annuitant lives. These payments continue even after the initial investment has been paid out, regardless of market performance. Costs typically range from 40-75 basis points.” *Walt R. Burkley, Variable Annuity Basics, Research & Management Company, Copyright 2008 Practising Law Institute; National Association Variable Annuities.*

“Guaranteed Minimum Income Benefits” (GMIB) – Generally, this benefit guarantees that when a contract is annuitized, the income will be based on the greater of the actual contract value or a minimum pay-out base, determined by using a guaranteed minimum annual compounding rate, typically ranging from 4%-5%. This rate is guaranteed regardless of market conditions. Typically, a 10-year holding period applies. Costs typically range from 50-75 basis points.” *Walt R. Burkley, Variable Annuity Basics, Research & Management Company, Copyright 2008 Practising Law Institute; National Association Variable Annuities.*

“Guaranteed Minimum Withdrawal Benefit” (GMWB) – This benefit guarantees a return of principal over time through systematic withdrawals. Typically, the amount of the withdrawal is 5-7% annually for a specified period of time until the entire amount of paid premiums has been withdrawn, regardless of market performance. Some contracts require assets to be allocated in specified investment options to access this benefit. Costs typically range from 35-75 basis points.” *Walt R. Burkley, Variable Annuity Basics, Research & Management Company, Copyright 2008 Practising Law Institute; National Association Variable Annuities.*

“Guaranteed Minimum Accumulation Benefits” (GMAB) – Generally this benefit guarantees that the variable annuity contract value will be at least equal to a certain minimum amount (typically the premium amount), regardless of market performance. At the end of a vesting period (typically 10 years) if the contract value is below the specified minimum, the issuer will add the difference between the current contract value and the initial premium (minus withdrawals). Some contracts impose asset allocation restrictions. Costs typically range from 25-50 basis points.” *Walt R. Burkley, Variable Annuity Basics, Research & Management Company, Copyright 2008 Practising Law Institute; National Association Variable Annuities.*

Issuers who emphasize the value of non-tax aspects of variable annuities are correct to the extent that nontax aspects of the variable annuity are appealing to the public. The product feature responsible for much of the newly found popularity of the variable annuity is the Living Benefit. Tergesen, “The Downside of Market-Proof Annuities”, January 28, 2008 Business Week. At least 80% of the variable annuities currently on the market have Living Benefit features. Tergesen, “The Downside of Market-Proof Annuities”, January 28, 2008 Business Week. A senior executive of a major annuity issuer, when interviewed, stated, “[r]ight now, it's a situation where folks are trying to get a sliver of the competitive angle, primarily in withdrawal benefits....The arms race in the living-benefits world is crazy....” Mercado, Darla, "Insurance Carriers Gear Up For VA Product Season New Offerings Such As Enhanced Riders, More Subaccount Choices Mark 'New Model Year'" Vol. 12; Issue 19 *Investment News* May 12, 2008. BusinessWeek reported that "[w]ith baby boomers nearing retirement and corporations scaling back defined-benefit pension plans, the insurance industry is adding guarantees called living benefits to the plain old variable annuity. The

over-50 set is snapping them up. Since 2005, VA sales have risen 18%, after stagnating earlier this decade." Tergesen, "The Downside of Market-Proof Annuities" Vol. 4068 BusinessWeek January 28, 2008. Studies commissioned by the National Association of Variable Annuities indicate that living and death benefits are a major reason why producers recommend that their customers purchase variable annuities within their qualified plans. The Association's report on one such study states:

financial advisers feel it is the unique combination of income guarantees and insurance benefits that annuities provide that are driving their clients to include annuities in qualified plans or IRAs....Valuable annuity living and death benefits are important features that lead financial advisors to recommend the use of annuities in qualified plans or IRAs to their clients. In fact 70% of survey respondents cited the death benefit and 61% listed living benefits among the top three reasons for recommending annuities in qualified plans or IRAs. In addition, 66% of respondents named guaranteed lifetime income as one of the top three reasons. According to the study data, 42% of annuities sold by the respondents were placed into qualified plans. For the industry as a whole, approximately 60% of all annuity sales in 2004 were in qualified plans, further demonstrating that annuity sales representatives feel confident in the value these products provide.

NAVA, "Retirement Security and Income Guarantees- Top Reasons To Hold Annuities in Qualified Plans or IRAs, (March 15, 2006); see also NAVA, "Survey of Retirement -Minded Americans Underscores Value Of 'Living Benefit' Guarantees in 1.4 Trillion Variable Annuity Market (July 18, 2007); NAVA, "Annuity 'Living Benefits' Provide Unique Value to Retirement-Minded Americans" (Dec. 12, 2005).

Variable Annuities "Maturing" After The Purchasers' Actual Life Expectancy

Other variable annuity suitability cases merely allege that the annuity was scheduled to mature after the actuarial life expectancy of the plaintiff. In *Estate of Migliaccio v. Midland National Life Insurance Company*, 436 F.Supp.2d 1095 (C.D. Cal. 2006), one of the plaintiff's allegations was that the plaintiffs had been defrauded since the maturity date of the variable annuities at issue was beyond their life expectancies. A New York Stock Exchange Memo seemingly lends support to the assertion that such variable annuities may be unsuitable for their purchasers, The NYSE stated: "[a] customer of advanced years might lack the actuarial expectations necessary for a

deferred variable annuity to yield its benefit of income shelter versus costs, and his or her lower tax bracket might render such benefits marginal or negative.” NYSE Information Memo 05-54 (August 11, 2005).

Without more, however, the mere allegation of maturity date after actuarial life expectancy is, according to producers and issuers, an insufficient showing of unsuitability. The income benefits of many variable annuities are marketed and purchased as a safety net in the event the annuitant outlives expectations. In that event, a living benefit feature can be valuable. Stated otherwise, the variable annuity can insure against the possibility that the annuitant will outlive his or her money.

RICO

Some variable annuity suitability and disclosure claims have also been phrased in terms of RICO liability. The claims in the following RICO variable annuity cases survived preliminary motions. *National Western Life Insurance Deferred Annuities Litigation*, 2006 WL 3615129 (S.D. Cal. December 7, 2006); *Estate of Migliaccio v. Midland National Life Insurance Company*, 436 F.Supp. 2d 1095 (C.D. Cal. 2006).

State Regulation Of Insurance Products

State Insurance Department approval is usually required for variable product sales. Some states require separate approval for variable life and variable annuities. Additional approvals may be required if separate accounts are involved. Most state blue sky laws exempt variable products from registration requirements with state securities departments.

The *potential* for state regulation of variable products remains. Therefore, in any action involving a variable product, the applicability of state laws should be assessed. See e.g. California Title X §2534.2 (insurers’ written suitability standards for variable life insurance products); La.

37:8303 (variable life insurance); Mississippi 84-101.3 (variable life insurance); N.Y. Title XI §15.3 (annuities).

Some states have adopted the Uniform Securities Act. Uniform Securities Act of 1946. The Uniform Securities Act exempts insurance from regulation under state securities laws, but not under state insurance laws. Uniform Act §401(m).

The Future Of Variable Product And Insurance Product Litigation **Variable Annuities**

FINRA's annual examination priorities letter indicates that both FINRA and the SEC will, in their examination programs in 2008, give high priority to new NASD Conduct Rule 2821 regarding supervision of the sale of deferred variable annuity products. See FINRA's annual examination priorities letter available online at <http://www.finra.org/web/groups-comm/documents/home-page-p038169.pdf>. For additional information, see *Bingham McCutchen's Alert: FINRA's New Variable Rule: Heightened Suitability Supervision Documentation Training & Compliance Requirements Available Online* at <http://www.Bingham.com/media.aspx?mediaid=5744> (September 24, 2007).

Life Settlements

FINRA is concerned about sales practices and the vulnerability of the target market in connection with these products.

The owner of the life insurance policy may let it lapse, surrender it, or sell it in the secondary market. A life settlement involves the sale of an existing life insurance policy in the secondary market. Usually, sale in the secondary market produces a price less than the net death benefit but more than the cash surrender value. NASD Notice to Members 06-38 August 9, 2006. Life

settlements typically involve insureds with life expectancies of between two and ten years. See Investor Alerts “Seniors Beware: What You Should Know About Life Settlements” February 8, 2007 FINRA Investor Alerts.¹²

Commissions paid in connection with life settlement sales are high. NASD Notice to Members 06-38 at *2. In some cases, the commission is “up to 30% or more of the purchase price.” NASD Notice to Members 06-38 at *2. The NASD “is concerned that aggressive marketing tactics, fueled by high commissions, may lead to inappropriate sales practices in connection with these transactions.” NASD Notice to Members 06-38 at *2. Another factor is that life settlements can affect federal entitlement programs. Finally, it is difficult to determine whether the price being offered for a life settlement is fair due to limitations on the secondary market. FINRA investor alerts “Seniors Beware: What You Should Know About Life Settlements” February 8, 2007.

The NASD is concerned that insureds opting for life settlements may optimally be steered in the direction of either a 1035 exchange or a loan against the life insurance policy.¹³

Insurance and Income Benefits Without The Annuity

A product called an advanced life delayed annuity or longevity insurance would have no accumulated cash value and no benefits that are subject to inheritance. The product would be purchased by individuals at a young age at a cheap price and held throughout life with the payout

¹² Viatical settlements typically involve insureds with life expectancies of less than two years. *Id.*

¹³ Taxes are not paid on investment gains that generate through 1035 exchanges of one life insurance policy for another. If the only purpose is to change life insurance policies, a 1035 exchange is preferable. A loan against the policy’s value could be less costly than a life settlement.

beginning at ages 80-90. Moshe Milevsky, *Real Longevity Insurance With A Deductible: Introduction to Advance-Life Delayed Annuities*, 9 North American Actuarial Journal 109 (October 2005). See also Melanie Waddell, *Meeting The Need For Income: Manufacturers Roll Out Products To Keep The Cash Rolling in Retirement*, Investment Advisor Magazine, April 2006.

Guaranteed Life Withdrawal Benefits set a specified withdrawal rate after a certain date, and the annuity owner withdraws at his discretion, up to that rate. If contributed premiums are depleted, an insurance rider is triggered and regular payments in accordance with a contract are provided. Jack Sharry, *The Annuity Rider, Unmasked*, ON WALL STREET MAGAZINE, March 2006; Frank O'Connor, *An Expensive Guarantee?*, Financial Advisor Magazine, September 2006.

Whether guaranteed life withdrawal benefits and longevity insurance are “securities” will be governed by the definition of "security in the Securities Act of 1933, and the issue whether the "security is exempt will be governed by regulations and cases relating to section 3(a)(8) of The Act. See the analysis contained in W. Thomas Conner, *The New Generation of Guaranteed Retirement Products: Emerging Issues Under The Federal Securities Laws*, American Law Institute – American Bar Association continuing Legal Education, Conference on Life Insurance Company Products Copyright 2007 in the American Law Institute at page 21, et seq.