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TOPIC: Court Dismisses Suit Alleging Carrier Improperly Charged Compound Interest on Policy Loans

CITATION: Martin v. Metropolitan Life Ins. Co., No. 16-CV-00484 (U.S.D.C. N.D.Ca. April 12, 2016).

SUMMARY: A California federal court recently granted a life insurance carrier's motion to dismiss a putative class action claiming that the carrier charged compound interest on life insurance policy loans without proper authorization and in violation of California state law. The plaintiffs asserted that Metropolitan Life Insurance Company violated California's usury laws, initially enacted in 1918, by charging compound interest on policy loans without first obtaining the policyholder's written consent that interest on the loans would be compounded.

The carrier responded by arguing that life insurance companies were subsequently exempted from the 1918 law and that, even if the court found they were not exempt from the compound interest requirement of the law, it complied with the law's written notice provision.

The court found in favor of MetLife on both issues and dismissed the action. Specifically, the court held that "[a]s MetLife is exempt, it cannot be held liable for violating" the compound interest consent requirements of the 1918 law and, alternatively, even if MetLife were not exempt, it "affirmatively complied with the compound interest consent requirement."

RELEVANCE: The ability to borrow money from the cash value of a whole life or universal life policy is one of the many benefits to owning permanent life insurance. However, the issues raised in this case serve as a reminder that policyholders may not fully understand these loans and how they work. Indeed, there have been (and will continue to be) dozens of lawsuits around the country where policyholders claim that they were misled by agents and carriers about how policy loans work.

Consequently, it is important for brokers and agents to clearly understand the mechanics of how policy loans function in order to provide clear and concise information to prospective and current policyholders. The ability to communicate this information properly and accurately (and to document that you have done so) will help to minimize subsequent lawsuits concerning policy loans on whole life and universal life policies.

FACTS: California's usury restrictions have been described by many courts as a curious and confusing blend of several components of California law. The original usury restrictions were enacted in the early 20th century in order to prevent lenders from using their perceived collective monopoly power to take advantage of borrowers. These restrictions, the first of which was passed in 1918, set the maximum rates of interest that could be charged by lenders and also provide that interest may not be compounded "unless an agreement to that effect is clearly expressed in writing and signed by the party to be charged."

In 1934, the voters of California ratified an amendment to the state constitution, modifying parts of the 1918 initiative. Among other things, the amendment reduced the maximum permissible rate of interest a lender could charge and created an exemption for a select class of lenders. The amendment also empowered the legislature to regulate this exempt class of lenders. After another series of amendments, the legislature, in 1981, added insurers, like MetLife, to the list of exempt lenders. However, it has remained unclear precisely which of the provisions of the 1918 initiative the class of exempt lenders were exempted from, including whether they were exempted from the compound interest notice requirements contained in the 1918 initiative.

Plaintiffs Brenda Martin and Joseph Giordano purchased their respective whole life insurance policies from MetLife in 1992 and 1965, respectively. The policies pay a death benefit and accumulate a cash value from which the policyholder can borrow money. "The insured either can repay the loan directly in cash or use the cash value of the policy itself for repayment. If an insured person dies with a loan balance remaining, MetLife reduces the death benefit it pays by an amount necessary to cover the outstanding loan balance. If the policy is cancelled before the insured's death, the 'surrender value' paid to the policyholder is reduced by the amount of any outstanding loan balance. In short, the loan balance, including interest, eventually is paid either by the policyholder herself, or if she dies, the subsequent beneficiary of the insurance."

Each plaintiff completed, signed, and submitted an application to MetLife in connection with their respective policies. The applications did not contain a provision allowing for the compounding of interest on policy loans, however the policies "describe in detail the manner in which compound interest may accrue" and explain "how interest could be compounded in certain circumstances." Furthermore, the policies specifically state that "the application and policy together constitute the contract between the insured and the insurer."

Giordano first took out a policy loan on his policy in and around 1975 and Martin first took out a policy loan around 2001. Subsequently, they both "eventually learned that MetLife compounds interest on all policy loans, even though this practice was not disclosed on the applications." Martin and Giordano elected to file a putative class action lawsuit against MetLife in 2015. At the core of the suit is the allegation that MetLife violated California law by charging the plaintiffs compound interest on policy loans without first obtaining their written consent.

The plaintiffs filed a complaint in state court in California. All four of the plaintiffs' claims stemmed from the allegation MetLife unlawfully charged them compound interest without a written agreement signed by the borrowers.

MetLife removed the matter to federal court and then immediately filed a motion to dismiss arguing that (1) insurers such as MetLife have been exempted from the compound interest consent requirements in the original 1918 usury law; and (2) that, in the alternative, it complied with the compound interest consent provision.

In addressing the first argument, the court engaged in a lengthy analysis of the various components of California's usury laws, a legal amalgam consisting of the California State Constitution, statutory law, and relevant case law. The court ultimately determined that the 1934 constitutional amendment empowered "the California legislature to regulate compound interest as a form of 'compensation' exempt entities [which subsequently came to include insurers such as MetLife] 'receive from a borrower in connection with any loan.'" This provision conflicts with [the 1918 initiative] and thus supersedes the [1918] [i]nitiative's consent requirement, meaning exempt entities like MetLife cannot be held liable for violating the consent requirement." Simply put, insurers such as MetLife are exempt from the compound interest consent requirements prescribed in certain circumstances by California law.

Even though the resolution of the first argument was enough to grant the motion to dismiss, the court still addressed the second argument finding again in favor of MetLife. MetLife argued that "it complied with the [1918] initiative because it obtained Martin and Giordano's affirmative consent to its levying compound interest under appropriate circumstances. Specifically, plaintiffs signed and submitted an application to obtain their respective policies, which provide the application and policy together constitute the contract between the insured and the insurer." On the other hand, the plaintiffs argued that "the compound interest disclosure did not appear in the insurance application, and the only piece of paper that felt the ink of their pens was the application, not the policy itself." MetLife countered that while the plaintiffs signed only their respective applications and not their policies, and it was in fact the policies that provided for the compounding of interest, the policies and the California Insurance Code provide that "the application is part of the contract where it is attached to or indorsed upon the policy as it is here."

In finding in favor of MetLife, the court stated that "[a]ll told, MetLife has demonstrated adequately it complied with the compound interest consent requirement. Section 2 of the [1918] initiative mandates borrowers must agree in writing to pay compound interest. The complaint concedes MetLife's policies explicitly disclosed the compounding of interest, and plaintiffs do not challenge the adequacy of either disclosure. Plaintiffs signed only their applications, but the policies and Insurance Code provide the application is part of the contract. Accordingly, the agreement clearly disclosed the compounding of interest, and plaintiffs gave written consent to such charges." Consequently, all four of the plaintiffs' claims were dismissed without leave to amend.

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