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Automatic liability: New risk under California's insurance lapse protection statutes

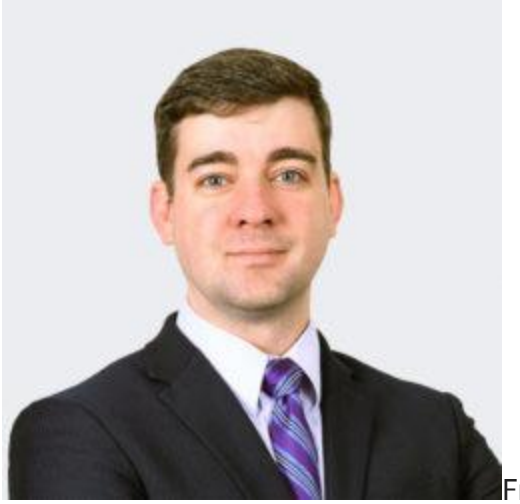
By Josh Lerner and Fred Clarke

Last year, the Supreme Court of California held that changes in the California Insurance Code's life insurance anti-lapse statutes apply to all life insurance policies that were in force when the statutes became effective in 2013. *See McHugh v. Protective Life Ins. Co.*, 494 P.3d 24 (Cal. 2021). Subsequent case law has led to controversial results, finding that an insurer breaches its policy when it fails to comply with the statutes even if a plaintiff has not paid premiums and cannot prove that the noncompliance caused harm.


Josh Lerner

Therefore, life insurance providers in California must tread carefully and strictly comply with the lapse protection statutes before terminating a life insurance policy for nonpayment. Failure to do so may result in automatic liability for breach of the policy.

The lapse protection statutes

 Fred Clarke

In 2012, the California legislature enacted protections to shield consumers from losing life insurance coverage due to missed premium payments. These protections were codified in California Insurance Code §§ 10113.71 and 10113.72 (hereinafter, "the Statutes"), which became effective on Jan. 1, 2013.

Section 10113.71 requires each life insurance company issued or delivered in California to include a 60-day grace period after the premium due date before a life insurance policy can lapse or be terminated due to nonpayment. Section 10113.72 prevents the issuance of any life insurance policy in California unless and until the policy applicant has been given the right to designate at least one other person to receive notice of pending lapse or termination of a policy, if the lapse or termination is due to nonpayment of premium. Section 10113.72 also requires the insurer to notify policy owners annually of this right to designate.

McHugh v. Protective Life: (non)retroactive application of the Statutes

McHugh involved a claim under a $1 million life insurance policy issued before the Statutes became effective, but terminated due to nonpayment in Mach 2013, shortly after the Statutes went into effect.

When the insurer denied a claim for benefits, the beneficiaries sued for breach of contract and bad faith, arguing that the Statutes applied to the policy even though it was issued before 2013, and that the policy could not have been terminated because the insurer did not satisfy the Statutes' grace period and right-to-designate requirements. The insurer argued that the Statutes could not retroactively apply to policies issued before Jan. 1, 2013. The Supreme Court of California agreed with the beneficiaries.

The court found that the Statutes do not disrupt liability expectations but "merely impose additional rules on insurers as a condition of doing business in California" by altering the procedure for terminating a life insurance policy in the future. The court went on to declare that "any nominal retroactive effect arguably at issue here plainly

fails to present the type of concern underlying the application of the presumption" against retroactive application. Thus, *McHugh* held the Statutes' grace period and right-to-designate requirements apply to all individual life insurance policies in force on Jan. 1, 2013.

Thomas v. State Farm: Automatic breach of contract liability

Although *McHugh* resolved the legal reach of the Statutes to policies issued before 2013, practical application of *McHugh* has led to controversial results in subsequent cases. Most notably, the Ninth Circuit construed *McHugh* to eliminate two elements of a breach of contract claim under California law. *Thomas v. State Farm Life Ins. Co.*, 2021 WL 4596286 (9th Cir. Oct. 6, 2021).

Thomas involved two life insurance policies issued in 2008, which the insurer terminated for nonpayment in 2016. The insured died in 2017. When the beneficiary sued for benefits, the trial court granted summary judgment to them based on the holding in *McHugh*. The insurer appealed, arguing that plaintiff failed to prove causation because she did not prove that the policies would not have lapsed even if the insured had complied with the Statutes. The Ninth Circuit affirmed on narrow grounds, finding that under *McHugh*, the insurer's "failure to comply with these statutory requirements means that the policy cannot lapse." Because of the policies could not lapse, the Ninth Circuit held that the insurer "breached its contractual obligations by failing to pay benefits to Thomas under the policies after Flynn's death."

Thomas appears to contradict the reasoning in *McHugh*. In order to prevail on a breach of contract claim in California, a plaintiff must prove both that they performed their own contractual obligation and that the defendant's breach caused them harm. Relieving a plaintiff of the burden to prove these elements disrupts the liability expectations of the parties, which is the kind of substantive effect the *McHugh* Court said should be precluded. Nonetheless, under *Thomas*, a failure to comply with the Statute's requirements creates near automatic liability for breach of contract.

Other legislation further complicates this liability. In 2020, California's legislature enacted the Unclaimed Life Insurance and Annuities Act, which requires life insurance companies, upon lapse of a policy, to locate and pay benefits to the policy beneficiary or, if no beneficiary can be found, to remit the funds to the state of California. Thus, if an insured dies after 2013, but before an insurer complies with the Statutes' right-to-designate requirement, the policy may never lapse, and the insurer is liable (to the beneficiary or the state) for the full death benefit under the policy.

The soundness of *McHugh* may be challenged based on the results in subsequent case law. In the meantime, however, insurers must be diligent in complying with the lapse protection statutes before terminating policies for nonpayment.

Josh Lerner is a shareholder with the Florida and Alabama law firm RumbergerKirk. He is a member of the Insurance and Reinsurance Committee of the

International Association of Defense Counsel. He can be reached at josh.lerner@innfeedback.com.

Fred Clarke is an associate in RumbergerKirk's Birmingham, Ala., office. He is a commercial litigator, whose practice includes the representation of life insurers and others in the financial services industry. He can be reached at fred.clarke@innfeedback.com.