MEMO# 19980

April 27, 2006

Appellate Court Upholds V.A. Contract Holder's Suit Seeking Performance of Provisions Permitting Market Timing

 [19980] April 27, 2006 TO: VARIABLE INSURANCE PRODUCTS ADVISORY COMMITTEE No. 2-06 OPERATIONS COMMITTEE No. 12-06 SEC RULES COMMITTEE No. 20-06 COMPLIANCE ADVISORY COMMITTEE No. 9-06 RE: APPELLATE COURT UPHOLDS V.A. CONTRACT HOLDER'S SUIT SEEKING PERFORMANCE OF PROVISIONS PERMITTING MARKET TIMING The United States Court of Appeals has upheld the right of a variable annuity contract holder to sue the issuer of the contract for specific performance of provisions in the contract that permit the holder to market time mutual funds.* Based on the court's holding, the case has been remanded to the lower court for further proceedings consistent with the holding. The facts of the case are briefly summarized below. BACKGROUND The plaintiffs in this action are a profit sharing plan and its trustees. The defendant is a life insurance company that, between February 1998 and March 1999, sold the plaintiffs seven flexible variable universal life insurance policies containing an investment feature that permits the plaintiffs some control over the investment of accumulated reserves. Pursuant to the policies' terms, the defendant maintained a unit investment trust that, in turn, was divided into various mutual fund subaccounts, in which the plaintiffs were entitled to invest a portion of the net premiums paid. The cash values of the policies were tied to the market value of the assets held in these subaccounts. While the defendant's standard policies provided that (1) "written" transfer requests could be made only four times in a policy year and (2) transfers would be made on the first valuation date after the request was received, the plaintiffs negotiated alternatives to these two provisions. Pursuant to a written agreement with the defendant, the plaintiffs were expressly authorized to engage in market timing and late trading. In particular, they were authorized to (1) make daily transfers by telephone, * See Paul M. Prusky et al. v. Reliastar Life Insurance Company, No. 05-1611 (3d Cir. Jan. 27, 2006). The court's decision is available at: http://www.ca3.uscourts.gov/opinarch/051611p.pdf. 2 fax, or other electronic means in unlimited amounts and without any transfer fees and (2) execute trades until 4:00 p.m. Central Standard Time (CST) with such trades receiving the values calculated for that trading day. In November 2002, the defendant informed the plaintiffs that they could no longer engage in late trading and only those trades received before 3:00 p.m. CST would receive that day's price. While the plaintiffs objected to this unilateral change to their agreement, they continued to do business with the defendant and the defendant continued to honor all electronic trades received from the plaintiffs. On October 8, 2003, the defendant notified the plaintiffs that, based on a complaint from a

mutual fund, the defendant would no longer accept trades in that mutual fund via fax, phone, or internet. In November 2003, this restriction was imposed on all the plaintiffs’ fund trades, thereby eliminating the plaintiffs’ ability to execute daily trades in accordance with their market timing strategy. In response, the plaintiffs filed suit seeking damages for breach of contract and specific performance of the market timing provisions in their agreement. (They did not seek damages or specific performance for elimination of their late trading privileges.) THE COURTS’ DECISIONS In the lower court, the plaintiffs moved for partial summary judgment on liability. The defendant opposed the motion asserting, among other things, that because the late trading provisions were both illegal and an integral part of the contract between the parties, the policies were void in their entirety. The lower court accepted this argument, denied the plaintiffs’ motion for summary judgment and, sua sponte, entered summary judgment in favor of the defendant. The plaintiffs then appealed to the Court of Appeals. For the reasons discussed below, the appellate court held that the lower court erred on the merits, reversed that court’s decision, and remanded the case for further proceedings. Primary Purpose of the Contracts Under Pennsylvania contract law, a party may enforce legal provisions of a contract containing an illegal provision provided that the primary purpose of the contract, or an essential part of the agreed exchange, is not affected by disregarding the illegal provision. According to the court, the primary purpose of the contracts at issue was to ensure the lives of two of the plaintiffs, while simultaneously providing savings and investment opportunities. This purpose could be accomplished without the illegal late trading provisions. Also, the plaintiffs’ use of the contracts as investment vehicles was not meaningfully impaired by striking the provisions relating to late trading. In this regard, the court noted that, for more than a year after the plaintiffs were prohibited from late trading, they continued to place numerous trades with the defendant, which the defendant honored. Impracticality of Performance The defendants argued that regulatory developments designed to deal with market timing had rendered the performance of the market timing provisions of the policies impractical and impossible. 3 The court found that the defendant had, in fact, allowed the plaintiffs to execute frequent transfers via electronic means. This clearly indicated that the contract could be performed. Moreover, there was no regulation that prevented the defendant from executing frequent transfers submitted electronically. In the court’s view, while regulators may have focused more attention on the adverse effects of market timing, and while the regulatory focus on market timing may have imposed additional difficulties on the defendant in conducting transactions, the regulatory focus and increased burdens did not render performance impracticable. In a footnote to this discussion in the decision, the court questioned whether increased regulatory scrutiny of market timing could be considered changed circumstances at all. According to the court, the “practice of market timing was well known at the time [the policies were drafted], as were the funds’ distaste for such practices.” Public Policy Considerations The defendants also argued that the market timing provisions in the policies, although not illegal, were not enforceable because they violated public policy. In particular, the defendant asserted that market timing was a “disruptive” and “suspect and disfavored activity.” The court responded that, under the law, “[p]ublic policy is to be ascertained by reference to the laws and legal precedents and not from general considerations of supposed public interest.” The court held that the defendant’s nonperformance of the market timing provisions could not be excused on public policy grounds because the court found “no basis in the laws or legal precedents to conclude that market timing is contrary to public policy.” As mentioned above, based on the court’s holding, the case was remanded to the District Court for further proceedings. According to the Court of Appeals, on remand, the “impact of [the SEC’s newly adopted redemption fee rule, Rule 22c-2] and other recent developments on the rights and duties of the parties may be considered.” Tamara K. Salmon Senior Associate Counsel