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CLASS ACTIONS

Trial courts' ''rigorous analysis'' of Rule 23 issues, which includes an evaluation of the merits should they be relevant to class certification, should extend to the consideration of potential contractual ambiguities, say attorneys Jason H. Gould and James C. Goodfellow in this BNA Insight. Contending that courts should treat this analysis as they do with *Daubert* motions, the authors say two recent federal court decisions—the Northern District of California's *In re Conseco* decision, and the Eighth Circuit's decision in *Avritt v. Reliastar*—highlight the importance of including this analysis at the class certification stage. Examining the two cases closely, the authors say *Conseco* should have included a more rigorous review, and *Avritt* is the better model for future cases involving potential contract ambiguity.

Rigorous Class Certification Analysis Requires Determination Of Whether Contractual Provisions at Issue Are Ambiguous

BY JASON H. GOULD AND JAMES C. GOODFELLOW

Class certification determinations force federal district courts to balance two competing legal principles. Courts must focus on the requirements set forth in Federal Rule 23, which, in theory, precludes substantive determinations on the merits of the underlying claims. But they must also conduct a ''rigorous analysis'' of the Rule 23 issues, which may include an evaluation of the merits should they be relevant to class certification. There are myriad reasons for such review. Courts rightly are concerned with the possibility of massive damages awards, and the corresponding pressure to settle. Moreover, res judicata may bind all class members, whether absent or not, and whether on notice or not.

Accordingly, courts properly examine issues relevant to class certification even if analysis of the merits is required. A common example is the evaluation of *Daub-*

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ert motions, which some circuit courts now resolve at the class certification stage.[1] Other merits-based issues also should be resolved at the class certification stage, such as breach of contract claims, which may be susceptible to class action treatment when there are no individualized point-of-sale differences or competing contract interpretations. Ambiguous contract language and the attendant need for extrinsic evidence have been sufficient to defeat class certification. Because the existence of ambiguity can be determinative of class certification, courts should treat this issue as they do *Daubert* motions.

Two recent decisions – *In re Conseco Life Insurance Company LifeTrend Insurance Sales and Marketing Litigation* (''*Conseco*'') and *Avritt v. Reliastar Life Insurance Company* (''*Avritt*'') – highlight the importance of including this analysis at the class certification stage. This article examines why the *Conseco* decision should have included a more rigorous review and why the *Avritt* decision is the better model for future cases involving potential contract ambiguity.

The Ruling in *Conseco*

In *Conseco*, the Northern District of California certified a Rule 23(b)(2) class whose representatives had asserted a breach of contract claim. Specifically, the suit centered on Conseco's implementation of changes to two of its life insurance policies, ''LifeTrend 3'' and ''LifeTrend 4.''[2] Generally, life insurance is intended to mitigate the financial risks associated with loss of life. In exchange for payment of a premium, the insured's beneficiaries are guaranteed a defined amount of money if the insured dies during the term of the policy.[3]

The policies required the plaintiffs to pay an annual premium into an ''accumulation account,'' which accrued a minimum interest rate. Monthly ''cost of insurance'' and ''expense'' charges were deducted from the accounts. The cost of insurance charge was based on Conseco's future mortality experience. The policies contained a table that set forth the maximum charge. The expense charge was capped at $5 per month.

These policies also contained an ''Optional Premium Payment Provision'' that enabled policyholders to reduce or eliminate their premiums, if, after five years, the account balance met or exceeded the guaranteed cash value plus the applicable surrender charge and any indebtedness. If the account balance fell below this threshold, premiums would recommence.

According to the plaintiffs, in October 2008, years after electing the ''Optional Premium Payment Provision,'' Conseco announced that the plaintiffs' policies had become underfunded because of planned increases to the cost of insurance and expense charges, resulting from changes in mortality experience, and presented the plaintiffs with several options to account for the underfunding.

However, following intervention by state insurance regulators, Conseco backed away from its October 2008 letter and eventually reached a settlement with the regulators, which allocated $10 million for all policyholders who elected to participate in the settlement. Such policyholders would have the option to cease payment of future premiums and select a reduced ''paid-up'' policy in the amount of the current accumulation account balance less any indebtedness. Or, policyholders could choose to continue paying premiums and reduce the cash value of their policies to an agreed upon amount. No policyholder, including those not participating in the settlement, would have to make any shortfall payments, and any previously paid shortfall payments were to be refunded. All policyholders could make flexible premium payments, and Conseco could not terminate any policyholders' benefits for failure to pay premiums.

The plaintiffs asserted that, despite the settlement, ''Conseco still intends to commit many of the most egregious contractual breaches announced by the company in the October 2008 Letter. . . .''[4] Specifically, the plaintiffs alleged that their policies provided for a ''Guaranteed Cash Value,'' and once a policyholder elected the ''Optional Premium Payment Provision,'' the Guaranteed Cash Value would be set at $0. The plaintiffs alleged that Conseco improperly intended to calculate underfunding without setting the Guaranteed Cash Value at $0. The court stated: ''[t]he import of the plaintiffs' interpretation is that, once a policy holder entered the [Optional Premium Payment Program] and stopped or reduced his premiums, the [Guaranteed Cash Value] would no longer figure into the calculation of whether his policy had become underfunded and therefore required the payment of additional premium payments. . . .''[5]

The plaintiffs further alleged that Conseco intended to increase cost of insurance rates even though the carrier's mortality experience had improved, and that the planned increase in expense charges bore no relationship to actual expenses. Not lost on the plaintiffs was the alleged effect of the economic downturn on Conseco, as they alleged that the proposals violated the policies' ''Non-Participating'' provision, which prohibits any sharing of Conseco's profits and losses.[6]

The *Conseco* court identified the potential for ambiguity, but punted on the determination.

In its decision, the court first focused on Rule 23(a)(2)'s ''commonality'' requirement and rejected Conseco's arguments that individual questions of both law and fact precluded class certification. Specifically, the court concluded that ''Conseco has not identified any state-to-state variations in the law governing declaratory judgment, and Conseco overstates the extent of any variations in state contract law including . . . the admissibility of extrinsic evidence.''[7] It emphasized that ''several courts have recognized that the law relating to the element of breach does not vary greatly from state

[1] *See, e.g., Am. Honda Motor Co. v. Allen*, 600 F.3d 813 (7th Cir. 2010) (''the district court must perform a full *Daubert* analysis before certifying the class if the situation warrants.'').

[2] *In re Conseco Life Ins. Co. LifeTrend Ins. Sales & Marketing Litig.*, Nos. 10-02124, 08-05746, 10-00652, 2010 WL 3931096, at *1 (N.D. Cal. Oct. 6, 2010).

[3] *See* Kenneth Black, Jr. & Harold D. Skipper, *Life & Health Insurance*, at 2 (13th ed. 2000) (''Black & Skipper'').

[4] *Conseco*, 2010 WL 3931096, at *3.

[5] *Id.*

[6] *Id.*

[7] *Id.*

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to state . . . and plaintiffs have persuasively rebutted Conseco's assertions concerning variations in the causation and damages elements of the contract claim.''[8]

Importantly, it concluded that ''as neither party has asserted that the form policy contract contains ambiguous terms (*rather, they offer competing interpretations based on the face of the documents*), admission of extrinsic evidence should not be necessary to interpret the contractual provisions at issue.''[9] The court summarized: ''[a]t best, Conseco has pointed to isolated and relatively minor variations that may be handled at trial by grouping similar state laws together and applying them as a unit.''[10] Additionally, the court concluded that there were no significant individual issues of fact. It stated that ''as long as plaintiffs are willing to attempt to prove their claims based solely on the policy documents . . . the Court does not believe that a significant amount of individualized proof will be required.''[11]

The court then addressed whether certification would be appropriate under Rule 23(b)(2). It concluded that ''[t]here is no dispute that every member of the potential class held a LifeTrend policy with identical language, or that the regulatory settlement sets forth certain directives which uniformly affect all class members. Conseco's proposed actions either amount to a breach of contract or they do not. Plaintiffs' breach of contract claim is amenable to uniform, class-wide adjudication, and involves future actions which can be enjoined on a class-wide basis.''[12] It found that plaintiffs' request for monetary relief was incidental to their request for declaratory relief.

Ignoring the Ambiguity Issue

The *Conseco* court's conclusions raise an interesting question with respect to the ''rigorous analysis'' that courts employ when analyzing class certification petitions. When a court certifies a class, it must focus on whether Rule 23's requirements are met. These are not merits determinations per se, but the analysis ''will often . . . require looking behind the pleadings . . . to issues overlapping with the merits of the underlying claims'' when those issues are relevant or determinative of the class certification motion.[13] Class certification determinations require the resolution of ''all factual or legal disputes relevant to class certification, even if they overlap with the merits-including disputes touching on elements of the cause of action''; and even at the certification stage, a court may ''consider the substantive elements of the plaintiffs' case in order to envision the form that a trial on those issues would take.''[14]

The *Conseco* court conducted something less than this ''rigorous analysis.'' As discussed above, the court refused to entertain whether a contractual ambiguity existed because ''neither party [had] asserted that the form policy contract contains ambiguous terms.''[15] This enabled its conclusion that extrinsic evidence was not necessary to interpret the contractual provisions at issue, which in turn supported its certification of the class. But many breach of contract disputes pit competing interpretations against one another, with neither side conceding even the slightest ambiguity.

The *Conseco* court should have conducted an independent analysis of whether the provisions at issue were unambiguous and thus properly resolved on a class-wide basis. Breach of contract cases where there is no ambiguity may be more susceptible to class certification.[16] Ambiguity, however, requires the admission of extrinsic evidence, which can fatally undercut class certification petitions.[17] Accordingly, like *Daubert*, contractual ambiguity is relevant to Rule 23 determinations.

This is all the more true when insurance contracts are involved. In the Ninth Circuit, as in most U.S. courts, insurance contracts are interpreted by the court as a matter of law.[18] So strong is this principle in the Ninth Circuit that ''leaving the interpretation of a[n insurance] contract to a jury is error.''[19] Axiomatically, ''[a]n insurance policy is ambiguous when it is capable of two or more constructions, both of which are reasonable.''[20]

The court, in essence, treated the question of ambiguity as if it had been waived by the parties. Yet it acknowledged that ''the parties offered competing interpretations based on the face of the documents,'' and that ''plaintiffs' contractual interpretations may ultimately be rejected at the summary judgment stage or *be disproved at trial*, but they are not patently untenable from the face of the documents. . . .''[21] Having all but concluded that the plaintiffs' interpretation was reasonable, the court should also have considered, for the purposes of conducting the necessary ''rigorous analysis,'' whether the defendant's interpretation was also reasonable.[22] Resolving the question of ambiguity would have been appropriate at the class certification stage, as the court would have performed its dual duties as arbiter of insurance contract language and gatekeeper for class certification. In this case, it abdicated one role in favor

[8] *Id.*
[9] *Id.* (emphasis added).
[10] *Id.* at *7.
[11] *Id.*
[12] *Id.* at *10.
[13] *Dukes v. Wal-Mart Stores, Inc.*, 603 F.3d 571, 581 (9th Cir. 2010) (en banc).
[14] *In Re Hydrogen Peroxide*, 552 F.3d 305, 317 (3d Cir. 2008).
[15] *Conseco*, 2010 WL 3931096, at *6.
[16] *See, e.g., Mortimore v. F.D.I.C.*, 197 F.R.D. 432 (W.D. Wash. 2000); *Heartland Commc'ns, Inc. v. Sprint Corp.*, 161 F.R.D. 111 (D. Kan. 1995); *Haroco, Inc. v. Am. Nat'l Bank and Trust Co. of Chicago*, 121 F.R.D. 664 (N.D. Ill. 1988).
[17] *See, e.g., Avritt v. Reliastar Life Ins. Co.*, 615 F.3d 1023, 1030 (8th Cir. 2010); *Bowers v. Jefferson Pilot Fin. Ins. Co.*, 219 F.R.D. 578, 580 (E.D. Mich. 2004) (denying certification, stating that the cases relied on ''do not involve competing interpretations of specific contract language''); *Adams v. Kansas City Life Ins. Co.*, 192 F.R.D 274, 281 (W.D Mo. 2000) (denying Missouri statewide class certification, upon a finding of ''some degree of ambiguity.'').
[18] *See, e.g., Barrett v. H.S. Weavers (Underwriting) Agencies Ltd.*, 70 F.3d 1277 (9th Cir. 1995); *Adler v. W. Home Ins. Co.*, 878 F. Supp. 1329, 1332 (C.D. Ca. 1995) (''Determining and giving meaning to an insurance policy is the responsibility of the Court. . . .'').
[19] *Adler*, 878 F. Supp. at 1332.
[20] *Conestoga Servs. Corp v. Exec. Risk Indem., Inc.*, 312 F.3d 976, 982 (9th Cir. 2002); *see also Adler*, 878 F. Supp. at 1333 (''An insurance policy provision is ambiguous when it is capable of two or more reasonable constructions.'').
[21] *Conseco*, 2010 WL 3931096, at *6 (emphasis added).
[22] *See In re Montgomery Ward & Co.*, 428 F.3d 154, 161 (3d Cir. 2005) (determining contractual ambiguity for the purpose of deciding class certification is a question of law).

of the other, and failed to apply a ''rigorous analysis'' to the class claims.

The *Avritt* Decision

The *Conseco* decision contrasts sharply with the Eighth Circuit's decision in *Avritt*, where the court addressed ambiguity at the class certification stage. In *Avritt*, the plaintiffs, California residents who held fixed deferred annuities, appealed from the Minnesota district court's order denying class certification. Generally, annuities are one type of financial instrument designed to minimize the risk of outliving one's assets, and are a form of insurance that offers safety of principal, guaranteed interest rates, and guaranteed income.[23] In exchange for premiums, the insurance company agrees to pay a stream of income over a certain period of time or for the remainder of the policyholder's life, provided that the policyholder complies with the terms of the contract.[24] In this respect, annuities are the opposite of life insurance. Deferred annuities, including those purchased by plaintiffs, require the initial premium to remain in deferral for a defined period, during which time interest accrues at or above a minimum guaranteed rate, and with payout beginning after the deferral period has been satisfied.[25]

The plaintiffs' claims centered on Reliastar's interest-crediting practices. Their policies guaranteed a minimum of 3% interest and also provided that ''from time to time, interest greater than the guaranteed rate may be credited in a way set by our Board of Directors,'' and that ''[t]here may be more than one interest rate in effect at any time.''[26] Reliastar's profit margin derived from the difference between the interest it earned and the interest it paid to policyholders, a common industry practice. Also, ''[f]or newer deposits, the spread between what [Reliastar] made on its investments and what it paid to a policyholder was typically 1% to 1.25% narrower—in other words, [Reliastar] made less profit'' on newer deposits, another common industry practice.[27]

In 2006, 14 years after their initial investment, the plaintiffs filed suit, alleging breach of contract. They argued that Reliastar's interest-crediting practices had been inadequately disclosed, and that Reliastar had inaccurately characterized this practice as being entirely dependent on the performance of the underlying investments, while omitting that it lowered interest rates on older deposits to recoup its initial subsidy of newer deposits. At all times, the interest earned was greater than 3%, and often ranged between 5% and 6%.

The district court denied Reliastar's motion to dismiss. When it addressed the class certification petition, it assumed without deciding that the plaintiffs could establish Rule 23(a)'s threshold requirements, but held that they could not satisfy Rule 23(b)(2) or (b)(3). The district court then dismissed the action after the plaintiffs conceded that they could not meet the amount in controversy requirement to sustain diversity jurisdiction.

The Eighth Circuit affirmed, and like the district court in *Conseco*, it addressed the breach of contract claim primarily in the context of Rule 23(b)(2). The court focused on the interpretation of the contract language. The plaintiffs argued that Reliastar had breached the policies by not crediting the nonguaranteed interest in a single way and by failing to have its board of directors set the way that the nonguaranteed interest would be credited.[28]

After first doubting whether this interpretation was reasonable, the court stated that ''[a]ssuming that the Avritts' interpretation of the contract is plausible, however, the existence of two or more reasonable interpretations opens the door for extrinsic evidence about what each party intended when it entered the contract. . . . Thus, Reliastar's liability to the entire class for breach of contract cannot be established with common evidence.''[29] Observing that the plaintiffs had conceded their breach of contract claim centered primarily on money damages, the court concluded that ''[Reliastar's] conduct cannot be evaluated without reference to the individual circumstances of each plaintiff,'' and that it was not possible to decide the contract claim in a uniform manner with respect to all plaintiffs.[30]

The court's consideration of the contract interpretation issue as a part of its class certification analysis was proper because it was relevant to the court's evaluation of the Rule 23 requirements. The *Conseco* court should have gone one step further and similarly evaluated whether the parties' dueling interpretations were plausible. In failing to do so, especially in light of the fact that the case involved insurance contracts, it fell short of the ''rigorous analysis'' that district courts must perform.

Conclusion

Class certification is a major event in a lawsuit. For all involved, these decisions can directly affect the disposition of a case. Just as some circuit courts now include *Daubert* motions in their ''rigorous analysis'' of class certification issues, contractual ambiguity should also factor into this ''rigorous analysis.'' Such determinations may well preclude certification in many instances. Conversely, there are cases where ambiguities can be resolved on a class-wide basis, and for those cases, making this determination at the certification stage can help streamline discovery, as the court's legal conclusions will guide the parties with respect to the type of evidence that will be required to resolve the ambiguity.

The *Conseco* court identified the potential for ambiguity, but punted on the determination. By certifying a class, it has increased pressure on Conseco to settle the case, and the potential ambiguity may never be resolved. Such precedent has the potential for wide-ranging effects on the rights of not only defendants, but also absent plaintiffs, especially in the context of Rule 23(b)(2) where no notice to class members is required. Indeed, as the Fifth Circuit has noted, in Rule 23(b)(2) class cases, there is a ''presumption with respect to the cohesiveness and homogeneity of interests among members of'' the class that renders the procedural

[23] *See* Darlene K. Chandler, *The Annuity Handbook* 64 (4th ed. 2005).
[24] *See* Black & Skipper, at 161-62 (13th ed. 2000).
[25] *Id.* at 164.
[26] *Avritt*, 615 F.3d at 1026 (8th Cir. 2010).
[27] *Id.* at 1027.
[28] *Id.* at 1029.
[29] *Id.*
[30] *Id.* at 1035-37.

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safeguards—class member notification and the ability to request exclusion—applicable to Rule 23(b)(3) classes unnecessary.[31] The more thorough approach of the *Avritt* court, which is supported by Ninth Circuit and California law, would have required the *Conseco* court to address more fully the issues relevant to class certification, benefiting all parties—plaintiffs, unnamed absent plaintiffs, and defendants alike.

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[31] *Allison v. Citgo Petroleum Corp.*, 151 F.3d 402, 412 (5th Cir. 1998).