Loyola Consumer Law Review

Volume 10 | Issue 2 Article 8

1998

Annuity Investors Held to Obligations Under Their Group Contracts

Bonnie Katubig

"no state action putting wealthy voters in a better position to contribute to campaigns than non-wealthy voters." Additionally, in *Smith*, African-Americans were denied the right to vote, and the Plaintiffs in this case made no such claim. The court refused to recognize the right to run a financially successful campaign, which it concluded was not comparable to the right vote. Additionally, the court noted that no voters' rights cases supported Plaintiffs' argument because Plaintiffs did not allege that they had lost their right to vote. Instead, Plaintiffs merely alleged that their ability to influence others prior to voting was diminished by their lack of wealth. The court held that there is no fundamental right for every voter to have the "same access to the campaigning process."

No Fundamental Right to Run for Office

The court next held that the system did not violate Plaintiff Lindner's fundamental rights as a candidate. The system neither violated his right to be on the ballot, nor his right to have information distributed to the public. The court stated that just as in *Kaplan*, the Sample Ballot and Voter Information Booklet provided only one way for candidates to communicate their qualifications to the public and candidates are only required to pay printing costs if they choose to use that method. Based on this reasoning, the court held that the County's "wealth primary" did not violate any fundamental rights and, therefore, did not qualify for a "heightened scrutiny analysis."

County Reimbursement System Passed the Rational Basis Test

Because the court found that the County's "wealth primary" did not burden a suspect class or a fundamental right, the court analyzed the County's judicial election process using the "rational basis" test. Under the "rational basis" test, a state action is valid when it is "rationally related to a legitimate purpose." Here, the court found that requiring candidates to pay the costs of printing their statements was rationally related to the legitimate goals of having candidates finance their own campaigns and keeping down the costs to the County. The court again emphasized that printing statements in the Ballot merely was one of many methods of running a campaign.

Without applying a "heightened scrutiny analysis," the court found that the County's judicial election process was valid because neither candidates nor voters have a fundamental right to judicial elections that are of equal access with regard to wealth. The court followed the Supreme Court, which has refused to recognize that every candidate has a right to an equal chance of success in election campaigns.

CLR

Annuity Investors Held to Obligations Under Their Group Contracts

By Bonnie Katubig

In ***Otto v. Variable Annuity Life Ins. Co.*, 134 F.3d 841 (7th Cir. 1998)**, the Court of Appeals for the Seventh Circuit affirmed the United States District Court for the Northern District of Illinois by holding that retirement annuity companies are held strictly and singly to the contractual obligations they set forth in their group contracts with their investors. Furthermore, the court found that challenges for breaches of contracts to those obligations must be supported fully in the contracts.

Retirement Investment Program Detailed Through Contracts

Beverly Otto and several teachers ("Plaintiffs") invested in retirement accounts with Variable Annuity Life

Insurance Company ("VALIC"), one of the companies their employers had chosen for group agreements. Each investor entered a group unit purchase ("GUP") contract with VALIC. Outlined in the GUP contract, investors could choose either the "Variable Annuity" or the "Fixed Dollar Annuity" investment account. Participants further retained the option to place their full investment in one account or divide their investment between accounts, and each account had differing rates of return and risks.

For variable accounts, the GUP specified that rates of return changed with trends in the market. Thus, investment risk was placed with the individual investor. VALIC guaranteed neither return of the principal nor return on investment. The variable account was listed as a security, and an annual prospectus helped explain it. For fixed accounts, the GUP guaranteed the principal with a 4% return on the total funds invested. Furthermore, any interest that accrued in the account became principal and "the 4% was guaranteed on that new combined amount." The GUP also stated that, at the discretion of VALIC's board of directors, a fixed account may earn "excess interest." VALIC intended to award this excess interest when there was a significant gap between market interest rates and the rate that applied to fixed accounts existed.

VALIC used one of two methods to credit interest to fixed accounts: the "banding" method or the "portfolio" method. Under the "banding method," VALIC chose a rate of interest similar to the rate of return the company realized on its investments. VALIC applied and guaranteed this rate of interest for funds invested in the fixed account during the respective investment period. If the market interest rates rose above the rate set by VALIC in that period, VALIC's board of directors could then exercise its right to award the excess interest. With each participant's earnings contribution, VALIC treated that amount as a new investment at the time it was contributed and applied the same rate set for that period.

Under the "portfolio method," VALIC paid a single interest rate on the full investment, regardless of the duration of the investment. VALIC based the interest rates it applied on the average rates of return the company realized in the market for all of its investments. Therefore, the interest rate under the "portfolio method" did not rise with the market as the rates using the "banding method" did. VALIC informed investors about their investment options in various ways. Once investors entered into the GUP contract with VALIC, they received a certificate detailing certain aspects of their investment. Investors next received an Owner's Manual, three of which were issued during the period in question, which provided a more comprehensive description of the investments. Furthermore, VALIC and its sales representatives "educated the employees of non-profit organizations . . . through meetings, phone calls and correspondence." Finally, VALIC sent variable account investors annual prospectuses, eight of which were in question in the case at bar.

Plaintiffs Contested Program's Method of Interest Crediting

Plaintiffs contended that the crediting method VALIC applied from 1979-82 had a negative impact on their investment. Plaintiffs had entered into a GUP contract with VALIC in March 1968. Until 1972, VALIC applied the "portfolio method" of interest to fixed account funds. VALIC then switched to the "banding method" and continued using that approach until 1982. With the interest rates remaining stable from 1975-78, VALIC was able to apply a steady 8% interest rate. However, from 1979-82, interest rates rose rapidly to the peak rate of 14.5%. While VALIC applied the higher interest rates to the new investments made in these years, the funds contributed prior to 1979 were permanently held at the lower rate of 8%. Plaintiffs therefore believed that VALIC undercut their return rates in the fixed accounts by using the "banding method," which held their previous investments to a depressed rate, instead of applying the "portfolio method," which would have credited the full fixed accounts with a rate closer to market average.

However, some participants realized how to avoid locking in their investments into the lower interest rates through the practice of "round tripping." "Round tripping" occurred when investors transferred their funds from the fixed to the variable and back again to the fixed account a day later. The participants' total investment would then receive the higher applicable interest rate instead of having a portion of their investment earn the lower rates of previous periods. "Round tripping" posed a financial threat to VALIC because VALIC could have been offering a rate of return on these accounts that was higher than the rate VALIC was receiving itself. VALIC realized that the practice was being used among its investors and accordingly altered the rules on transfers in 1979. Under the new rule, an investment transfer into a variable account from a fixed account had to last for 90 days before VALIC would recognize a retransfer to a fixed account as a new investment. While VALIC did not impair the investors' right to transfer funds, investors now bore the risk that the interest rate in the variable account would dip below that of the fixed account in the 90-day period. The investor also faced the risk that the fixed account interest rate would still be higher at the time of retransfer as it was when the funds were moved to the variable account.

Plaintiffs Appealed Jury Verdict, Jury Instructions, and Trial Court Errors

At trial, Plaintiffs contested two primary issues concerning VALIC's annuity investment program. First, Plaintiffs argued that VALIC violated Rule 10b-5 of the Securities Exchange Act of 1934 by intentionally failing to disclose pertinent investment information, including VALIC's use of the "banding method" of interest crediting on fixed accounts. Moreover, Plaintiffs claimed that VALIC hid the practice and the rules of "round tripping" from them. Secondly, they claimed that VALIC breached contractual obligations, including the obligation to employ the "portfolio method" of paying interest. As an alternative to the breach of contract theory, Plaintiffs contended that VALIC did not live up to their obligation of allowing "round tripping" when it instituted the 90-day waiting period for the retransfer of funds.

Citing no contractual relationship between Plaintiffs and certain Defendants, the district court initially found in favor of the Defendants, except VALIC. The jury deliberated the two counts against VALIC, and ultimately sided with VALIC. On appeal, Plaintiffs challenged four primary aspects of the trial claiming that: (1) the jury's entering of a verdict for VALIC was contrary to the evidence on both counts; (2) the district court, at the close of Plaintiffs' case, erroneously granted judgment in favor of VAMCO, a subsidiary of VALIC; (3) the lower court misinstructed the jury; and (4) the court erred by excluding pertinent evidence.

Court Criticized the Sufficiency of Plaintiffs' Contractual Evidence

The Seventh Circuit addressed each of Plaintiffs' contentions on appeal. The court first discussed the challenge to jury instructions used in the district court proceedings. In reviewing the jury instructions, the Seventh Circuit applied the rule from *United Airlines, Inc. v. United States*, 111 F.3d 551 (7th Cir.1997), by examining "whether the instruction misstates or insufficiently states the law." Plaintiffs contended that the jury should have received two sets of instructions concerning VALIC's contractual obligations. If the contract was deemed unambiguous, Plaintiffs requested jury instructions on the meaning of, and any duties arising from, that contract. In the alternative, if the contract was deemed ambiguous, Plaintiffs argued that the lower court should have highlighted the ambiguity and instructed the jury on how to clear it up.

However, the court at bar explained that Plaintiffs' argument relied on an erroneous assumption of what comprised the disputed contract. Plaintiffs pointed to language found in the GUP contract, enrollment certificates, owners manuals, and the annual prospectuses as their "contract" with VALIC. VALIC countered that this compilation of writings did not create the binding contract and argued that the GUP contract was the contract in question. Because the parties presented this dispute over what constituted the contract and its terms, the district court could not, as Plaintiffs suggested, give specific jury instructions about the alleged "contract." The Seventh Circuit ruled that the district court properly left this dispute for the jury, who could best determine the intent of the parties from the various documents. Thus, the court ruled that the trial court had neither misstated nor insufficiently stated the law when it instructed the jury "'to determine whether any or all of the contract terms asserted by Plaintiffs and denied by VALIC [were] terms of the parties' investment contracts.'"

Trial Jury Had Freedom to Determine Contractual Terms

The Seventh Circuit further rejected Plaintiffs' contention that the jury verdicts were contrary to the evidence. Relying on its ruling in *Dallis v. Don Cunningham & Assocs.*, 11 F.3d 713 (7th Cir. 1993), the Seventh Circuit examined the validity of the jury verdict on the contractual claim and the securities law violation by determining whether it had a "reasonable basis in the record." Plaintiffs maintained that, from the several documents that comprised their contract with VALIC, three contractual duties and subsequent breaches by VALIC could be identified. The court rejected each contention in turn.

First, Plaintiffs argued that VALIC was bound to follow the "portfolio method" of crediting interest. In support of their argument, Plaintiffs cited the GUP contract and the owners manual, saying the use of the "banding method" by VALIC resulted in a contractual violation. Because it had upheld the district court's decision to leave the dispute over the contract terms for the jury, the court determined that the jury was entitled to determine that the terms of the GUP contract were VALIC's only binding duties. Moreover, the court noted that neither the language of VALIC's owners manuals nor its GUP contracts required the "portfolio method" of crediting.

Likewise, the court rejected Plaintiffs' second argument that VALIC breached a contractual duty to provide a "complete profile" of all the participants' accounts. The court found no evidence of this promise in the GUP contract but only in the owners manuals, and the court concluded that the jury was free to decide that these manuals did not create any separate contractual duties. In addition, the court opined that even if VALIC had this contractual obligation, the jury could have determined that the quarterly reports on account interest and activity sent by VALIC satisfied this duty.

Lastly, the court disagreed with Plaintiffs' contention that the waiting period VALIC implemented to discourage "round tripping" breached VALIC's contractual obligation, allowing participants an unrestrained right to transfer. The court ruled that the jury had sufficient evidence to conclude both that the waiting period did not hamper the right of investors to transfer funds and that this type of company interference with investor "round tripping" did not violate VALIC's contractual duty. The court determined that since "round tripping" posed a financial threat to VALIC, it had the right to protect itself by instituting this waiting period. The waiting period did not impair the right to transfer but instead forced investors, not the company, to bear the risk of loss.

Alleged Violation of the Securities Exchange Act of 1934 Unsubstantiated

The court further ruled against Plaintiffs' allegation that VALIC violated Rule 10b-5 of the Securities Exchange Act of 1934. For the court to find a 10b-5 violation, Plaintiffs would have had to prove: "that (1) the defendant[s] made a false statement or omission (2) of material fact (3) with scienter (4) in connection with the purchase or sale of securities (5) upon which the plaintiff justifiably relied (6) and that the statement or omission proximately caused the plaintiff's damages." *See Caremark, Inc. v. Coram Healthcare Corp.*, 113 F.3d 645 (7th Cir. 1997).

Plaintiffs argued that VALIC deliberately failed to disclose to participants both that the company was crediting interest using the "banding method" and that the practice of "round tripping" was available. Plaintiffs contended that these were significant omissions which prevented the investors from understanding how to maximize their return on investment. Due to these omissions, participants claimed financial losses.

In reviewing these contentions, the court found that VALIC had notified investors of the "banding method" of crediting and that "round tripping" remained an investment option through various forms. Through VALIC's quarterly statements, participants could evaluate the current interest rates of both funds and of particular rates for the subsequent quarters. The court stated that the jury could have found that this method of disclosure revealed the "banding method." Moreover, the court supported its conclusion by pointing to various documents, which were sent to employment groups outlining the "banding method" and the stated sales practice of explaining "round tripping" to investors. Here again, the court ruled that there was sufficient evidence for the jury to find for VALIC.

Evidentiary Rulings Lacked Foundation

Plaintiffs also challenged two evidentiary rulings, which excluded a document known as the Hansen Report and an argument based upon VALIC's prospectuses. The court referred to the rule established in *Gagan v. American Cablevision, Inc.*, 77 F.3d 951 (7th Cir. 1996), and held that "we review motion in limine evidentiary rulings . . . under an abuse of discretion standard." The Hansen Report, prepared and provided to the Chicago Teachers

Union ("CTU") evaluated the "tax-sheltered annuity programs" available to union employees. The Hansen Report suggested that VALIC used the "portfolio method" while VALIC was actually using the "banding method." Plaintiffs maintained that VALIC did nothing to remedy this discrepancy in their reporting.

The court explained this holding by citing Plaintiffs' failure to authenticate the report which led to the presumption that the Plaintiffs relied on hearsay for their argument. As Plaintiffs had failed to assert an exception to the hearsay rule, the district court had not abused its discretion in excluding this evidence. The court also struck down the Plaintiffs' challenge concerning the prospectus legends by pointing to the express indication on the legend that "no person had the authority to give information or to make representations with respect to the 'offer contained in the prospectus.'"

Court Upheld Judgment in Favor of VALIC Subsidiary

Plaintiffs also contested the judgment in favor of VAMCO issued by the trial court. The court summarily dismissed this argument, stating that since VAMCO operated as a subsidiary of VALIC, and since VALIC had withstood the previous challenges from Plaintiffs, VAMCO was necessarily free of fault as well.

In sum, the Seventh Circuit of the United States Court of Appeals sent a warning to investors with this ruling that group participants will be held to the express contracts that they have made with their investment companies. CLR

Seventh Circuit Allowed Small Exception for Recovery Under the Carmack Amendment

By James J. Chandler

In ***Gordon v. United Van Lines*, 130 F.3d 282 (7th Cir. 1997)**, the United States Court of Appeals for the Seventh Circuit determined that the Carmack Amendment to the Interstate Commerce Act, 49 U.S.C. § 11707 (1994), governing shippers' rights to recover common carriers' losses to property, preempted only state law claims directly stemming from lost or damaged cargo that had been shipped interstate. In so finding, the court recognized that the Carmack Amendment did not preempt every state law claim because a person could still allege liability when his claim did not arise from the "actual loss of or damage to goods." Further, the Seventh Circuit held that the Carmack Amendment strictly prohibited the recovery of punitive and emotional distress damages. Last, the Seventh Circuit found that based on the expert testimony, the jury award was not excessive.

United Van Lines Acted in Bad Faith

Plaintiff Ruth Slavin ("Slavin"), an 80 year-old widow, decided to move from Florida to Chicago. After meeting with a United Van Lines' ("United") representative twice, Slavin decided to hire the company to move some boxes to her new house and her most important boxes to her daughter's, Rachelle Gordon's ("Gordon"), house. The latter boxes contained a large number of photographs of historic significance and personal value. These historic photographs were never insured because the United representative, aware of Slavin's limited mental and physical capabilities, "wrote in the bill of lading that Mrs. Slavin released United from any liability for loss or damage to the goods exceeding $1,000." However, United admitted at trial that it billed her for "Replacement Cost Protection" with a value of $10,000.

United's local agent, Cook