RENDERED: MAY 29, 2020; 10:00 A.M.
TO BE PUBLISHED

Commonwealth of Kentucky

Court of Appeals

NO. 2018-CA-001580-MR

LEGACY CONSULTING GROUP,
LLC; AND MONEY CONCEPTS CAPITAL
CORPORATION APPELLANTS

APPEAL FROM FAYETTE CIRCUIT COURT
v. HONORABLE ERNESTO M. SCORSONE, JUDGE
ACTION NO. 18-CI-00444

BRENDA GUTZMAN, IN HER CAPACITY
AS THE EXECUTRIX OF THE ESTATE
OF GRACE W. MCGAUGHEY, DECEASED;
AND JACKSON NATIONAL LIFE
INSURANCE COMPANY APPELLEES

OPINION
AFFIRMING

** ** ** ** **

BEFORE: GOODWINE, LAMBERT, AND K. THOMPSON, JUDGES.

LAMBERT, JUDGE: This is an interlocutory appeal in an action by Brenda

Gutzman, in her capacity as the Executrix of the Estate of Grace W. McGaughey,

related to the sale of a Jackson National Life Insurance Company ("Jackson National") annuity product to McGaughey prior to her death. Legacy Consulting Group, LLC ("Legacy Consulting"), and Money Concepts Capital Corporation ("Money Concepts") (collectively, "the defendants" or "the appellants") have appealed from the September 28, 2018, order of the Fayette Circuit Court denying their motion to compel arbitration or hold the underlying action in abeyance. We affirm.

The underlying action began with the filing of a complaint on February 7, 2018, by Gutzman, in which she was seeking relief pursuant to contract, tort, and statutory law related to McGaughey's purchase of a Jackson National annuity product. Legacy Consulting is a Kentucky corporation and is the successor corporation to Money Concepts. As such it is responsible for Money Concepts' liabilities. Jackson National is a Michigan insurance company authorized to do business in Kentucky. Gutzman alleged that the three defendants had fiduciary duties to McGaughey through their financial relationship. Gutzman alleged that they violated these fiduciary duties; breached the contract between them; violated the common law duty of good faith; and violated the implied covenant of good faith and fair dealing through marketing, promoting, and selling an annuity product to McGaughey that was unconscionable, unfair, inappropriate, and financially irresponsible due to her age and the state of her health. Gutzman

also alleged that the defendants violated Kentucky's Consumer Protection Act by using trade practices that were unfair, unconscionable, false, misleading, and deceptive, thereby entitling her to damages and equitable relief. By issuing the policy to McGaughey and denying the claim Gutzman made after her death, the defendants' actions were unfair, unconscionable, false, misleading, and deceptive. Gutzman alleged that the defendants knowingly, recklessly, and intentionally violated McGaughey's trust and unlawfully denied Gutzman's claim for benefits. She also alleged that McGaughey lacked the capacity to execute the insurance contract the defendants promoted and sold to her or that she was unduly influenced to purchase it. Gutzman sought compensatory damages pursuant to Kentucky Revised Statutes ("KRS") 446.070 and attorneys' fees pursuant to KRS 367.220(3), reformation of the insurance contract, and punitive damages based upon the defendants' fraudulent conduct. Gutzman filed a first amended complaint the next month. She alleged that Ryan McDaniel was an employee and/or agent of the defendants who was acting within the course and scope of his employment.

The defendants filed a motion to hold the action in abeyance and to compel arbitration, or, in the alternative, to dismiss the first amended complaint. First, they argued that Gutzman's amended complaint was vague and conclusory, and second, that there was a binding arbitration agreement. They believed this claim arose from a December 2009 agreement that converted an existing variable

annuity account into a Jackson National Life Insurance Company Perspective Variable Annuity ("the annuity") that was in the name of the William E. McGaughey Non Marital Trust ("the trust"). McGaughey was a trustee of this trust. Money Concepts was the broker-dealer, and Legacy Consulting was the independent financial advisory service that sold the annuity to her. When she purchased the annuity, McGaughey signed an Agreement to Arbitrate ("the arbitration agreement") in the Annuity Account Form ("the form"). The arbitration agreement, which is found on the tenth page of the eleven-page form, stated in pertinent part as follows:

AGREEMENT TO ARBITRATE

> The undersigned and Money Concepts Capital Corp. each agree that ALL CLAIMS OR CONTROVERSIES, and any related issues which may arise at any time between us (including Money Concepts Capital Corp.'s representatives, directors, officers, employees and agents) concerning any transaction or order; the conduct of Money Concepts Capital Corp. or its registered representatives, directors, officers, employees, and agents; the construction, performance or breach of this or any other agreement between us, whether entered into prior to, on, or subsequent to the date hereof; the breach of any common law or statutory duty; or the violation of any federal or state securities law, or any other federal or state law of any nature SHALL BE SUBMITTED AND RESOLVED BY ARBITRATION rather than by lawsuit in a court of law or equity. Any arbitration pursuant to this agreement shall be in accordance with and governed by, a mutually acceptable arbitral forum but in the absence of such agreement, the then Code of Arbitration Procedure of the National Association of Securities

Dealers, Inc., as then in effect. The award of the arbitrators, or of the majority of them, shall be final and binding, and judgment upon the award rendered may be entered in any federal or state court having jurisdiction. . . .

THIS AGREEMENT CONTAINS A PREDISPUTE ARBITRATION CLAUSE. BY SIGNING AN ARBITRATION AGREEMENT PARTIES AGREE AS FOLLOWS:

i. ALL PARTIES TO THIS AGREEMENT ARE GIVING UP THE RIGHT TO SUE EACH OTHER IN COURT, INCLUDING THE RIGHT TO A TRIAL BY JURY, EXCEPT AS PROVIDED BY THE RULES OF THE ARBITRATION FORUM IN WHICH A CLAIM IS FILED.

ii. ARBITRATION AWARDS ARE GENERALLY FINAL AND BINDING; A PARTY'S ABILITY TO HAVE A COURT REVERSE OR MODIFY AN ARBITRATION AWARD IS VERY LIMITED.

iii. THE ABILITY OF THE PARTIES TO OBTAIN DOCUMENTS, WITNESS STATEMENTS, AND OTHER DISCOVERY IS GENERALLY MORE LIMITED IN ARBITRATION THAN IN COURT PROCEEDINGS.

iv. THE ARBITRATORS DO NOT HAVE TO EXPLAIN THE REASON(S) FOR THEIR AWARDS.

v. THE PANEL OF ARBITRATORS WILL TYPICALLY INCLUDE A MAJORITY OF ARBITRATORS WHO WERE OR ARE AFFILIATED WITH THE SECURITIES INDUSTRY.

vi. THE RULES OF SOME ARBITRATION FORUMS MAY IMPOSE TIME LIMITS FOR BRINGING A CLAIM IN ARBITRATION. IN SOME CASES, A

CLAIM THAT IS INELIGIBLE FOR ARBITRATION MAY BE BROUGHT IN COURT.

vii. THE RULES OF THE ARBITRATION FORUM IN WHICH THE CLAIM IS FILED, AND ANY AMENDMENTS THERETO, SHALL BE INCORPORATED INTO THIS AGREEMENT.

. . . .

Page 6 of the form in the signatures section contains the following paragraph:

> The IRS does not require your consent to any provision of this document other than the certifications required to avoid backup withholding. The undersigned has/have carefully read all pages, and agree to the information disclosed by the undersigned, and to the terms and conditions contained herein. The undersigned further acknowledges receipt of, understanding of and full agreement with the terms and conditions contained in the Money Concepts Capital Corp. New Account Disclosure packet, which includes information on how they may obtain information about SIPC, a pre-dispute arbitration clause (Agreement to Arbitrate), the Money Concepts Capital Corp. Customer Privacy Notice, the Money Concepts Capital Corp. Business Continuity Plan summary, and the Product Sponsor Compensation disclosure.

McGaughey's signature appears immediately following this paragraph, dated December 10, 2009. David Hudson was listed as the registered representative.

Based upon the terms of the arbitration agreement, the defendants argued that the court should compel arbitration pursuant to the Federal Arbitration Act, 9 United States Code ("U.S.C.") § 1, *et seq.* ("the FAA") and KRS Chapter 417, Kentucky's Uniform Arbitration Act. In the alternative, the defendants

moved to dismiss the first amended complaint for failure to state a claim pursuant to Kentucky Rules of Civil Procedure ("CR") 12.02.

On March 30, 2018, Jackson National filed a motion to dismiss pursuant to CR 12.02 because the facts and legal theory did not support a claim for relief against it. It argued that, because the annuity was owned by a trust, only the trustee or a successor trustee had legal standing to bring a claim against Jackson National. Instead, the claim was brought by the executrix. Jackson National later filed a notice of cancellation of the hearing on this motion.

Also on March 30, 2018, Gutzman moved the court to file a second amended complaint, which was granted. The defendants filed another motion to hold the case in abeyance and compel arbitration, or to dismiss the second amended complaint. Jackson National joined in the defendants' motion to dismiss the second amended complaint.

In response, Gutzman first addressed the facts of this case, which she described as outrageous:

> The defendants marketed and sold an 89-year-old woman a half million dollar annuity with benefits for "LIFE ONLY." In other words, the annuity terminated with no residual benefits to her designated beneficiaries or heirs at her death. That occurred approximately three years after the inception of the annuity.

Gutzman argued that KRS 417.050(2) specifically exempts insurance contracts from arbitration provisions, that because this was purchased by a trustee an

arbitration clause could not be enforced unless the trust document expressly authorized the trustee to waive a jury trial or enter arbitration, and that it was unconscionable to force an arbitration agreement on an 89-year-old woman. In their reply, the defendants argued that the contract in this case was for a variable annuity, not an insurance contract subject to the McCarran-Ferguson Act, 15 U.S.C. §§ 1011-1015.[1] The parties continued to argue whether the annuity product McGaughey purchased was an insurance product or not.

The court held a hearing on the pending motions on August 31, 2018, during which the parties discussed whether the product was a fixed or variable

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[1] In *Patenaude v. Equitable Life Assurance Society of U.S.*, 290 F.3d 1020, 1026 (9th Cir. 2002), *abrogated on other grounds by Kircher v. Putnam Funds Trust*, 547 U.S. 633, 636 n.1, 126 S.Ct. 2145, 2150 n.1, 165 L.Ed.2d 92 (2006), the 9th Circuit Court of Appeals described the purpose of the McCarran-Ferguson Act as follows:

> The McCarran-Ferguson Act was passed by Congress in 1946 "to restore the supremacy of the States in the realm of insurance regulation." *United States Dep't of Treasury v. Fabe*, 508 U.S. 491, 500, 113 S.Ct. 2202, 124 L.Ed.2d 449 (1993). The Act provides, in relevant part: "No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance . . . unless such Act specifically relates to the business of insurance." 15 U.S.C. § 1012(b).
>
> The McCarran-Ferguson Act does not prevent Congress from regulating insurance. Rather, the effect of the McCarran-Ferguson Act is the avoidance of "*inadvertent* federal intrusion" into state insurance regulation. *Barnett Bank v. Nelson*, 517 U.S. 25, 39, 116 S.Ct. 1103, 134 L.Ed.2d 237 (1996) (emphasis in original). Thus, in accomplishing its ends, the McCarran-Ferguson Act "does not seek to insulate state insurance regulations from the reach of all federal law." *Id.* "It is only when a statute, by unintended implication, encroaches on the insurance regulatory regime of a state that McCarran-Ferguson prevents application of the federal statute." [*Lander v. Hartford Life & Annuity Ins. Co.*, 251 F.3d 101, 116 (2nd Cir. 2001)].

annuity. Gutzman argued that it was a fixed product based upon the Jackson National portfolio, which showed that it was for a fixed account with regular payments. Because the annuity was fixed, it was an insurance product rather than a security product. The defendants argued that the 2009 product was a variable annuity that was subject to SEC rules. For seven years, the account accrued interest at a variable rate, and the intent was for this to be an investment vehicle that would accrue interest on a variable basis. McGaughey chose fixed payments, but the annuity purchased was not fixed from the beginning. The variable nature of the underlying product was not changed by the decision to request fixed payments later.

After considering the parties' respective arguments, the court discussed the public policy in Kentucky to protect insurance contracts and decided that, because the product was somewhat of an insurance product, the arbitration agreement would not apply. On September 28, 2018, the court entered an order denying the motion to compel arbitration for the reasons stated on the record at the hearing. This appeal now follows.

On appeal, the defendants (now appellants) continue to argue that the arbitration agreement should be enforced because the product purchased was a variable annuity product, not a fixed annuity or insurance. Because this appeal concerns a purely legal question, our review is *de novo*. *Conseco Finance*

Servicing Corp. v. Wilder, 47 S.W.3d 335, 340 (Ky. App. 2001) (The trial court "based its ruling solely on the application of certain principles of contract law to the arbitration clause quoted above. Our review, accordingly, is *de novo*.").

In *Scott v. Louisville Bedding Co.*, 404 S.W.3d 870, 875 (Ky. App. 2013), this Court explained:

> "[A]rbitration is a matter of contract . . . [and] courts must place arbitration agreements on an equal footing with other contracts . . . enforc[ing] them according to their terms[.]" *AT & T Mobility LLC v. Concepcion*, – U.S. —, 131 S.Ct. 1740, 1745, 179 L.Ed.2d 742 (2011). As with any contract, parties to an arbitration agreement are free "to limit the issues subject to arbitration, . . . to arbitrate according to specific rules, . . . and to limit *with whom* [they] will arbitrate . . . disputes[.]" *Id*. at 1748-49 (Emphasis in original and internal citations omitted). When there are any doubts as to the scope of an arbitration agreement, those doubts should be resolved in favor of arbitration. *Hill v. Hilliard*, 945 S.W.2d 948, 951 (Ky. App. 1996).

KRS 417.050 addresses the validity of an arbitration clause, noting only a few exceptions, one of which is at issue in this case:

> A written agreement to submit any existing controversy to arbitration or a provision in written contract to submit to arbitration any controversy thereafter arising between the parties is valid, enforceable, and irrevocable, save upon such grounds as exist at law for the revocation of any contract. This chapter does not apply to:
>
> . . .
>
> (2) Insurance contracts.

The circuit court held, in this case, that the annuity agreement was an insurance contract and therefore ruled that the arbitration clause could not apply. The appellants argue that, because this case concerned a variable annuity, the annuity agreement was not an insurance contract, meaning that the arbitration clause would apply. On the other hand, Gutzman argues that a variable annuity is a hybrid variety governed by insurance law and that the annuity was fixed.

This Court described an insurance contract as follows:

> Generally, "[a]n insurance policy is a contract of indemnity[.]" *Buck Run Baptist Church, Inc. v. Cumberland Sur. Ins. Co., Inc.*, 983 S.W.2d 501, 504 (Ky. 1998). "[A]n indemnity contract creates a direct, primary liability between the promisor and promisee that is *original and independent of any other obligation.*" *Intercargo Ins. Co. v. B.W. Farrell, Inc.*, 89 S.W.3d 422, 426 (Ky. App. 2002) (original emphasis omitted; emphasis added). Additionally, "[a]n insurer expects losses, and they are actuarially predicted. The cost of such losses are [sic] spread through the market by means of a premium." *Buck Run Baptist Church*, 983 S.W.2d at 504-05. That is to say, "insurance contracts shift risk [among] policyholders." *Commonwealth v. Reinhold*, 325 S.W.3d 272, 277 (Ky. 2010).

Deans & Homer, Inc. v. Commonwealth, Public Protection Cabinet, Kentucky Dept. of Ins., 451 S.W.3d 659, 664 (Ky. App. 2014). The *Scott* Court also examined whether the agreement under review was an insurance contract, stating:

> "'Insurance' is a contract whereby one undertakes to pay or indemnify another as to loss from certain specified contingencies or perils called 'risks,' or to pay or grant a specified amount or determinable benefit or

> annuity in connection with ascertainable risk contingencies, or to act as surety." [KRS] 304.1-030. . . .
>
> . . . .
>
> Having reviewed the Agreement, we agree with the circuit court that it is an insurance contract. Bedding participated in the Trust in order to obtain indemnity for the risks of being self-insured. Pursuant to the Agreement, the Trust agreed to do so. Scott's argument that the Agreement is not an insurance contract because the only insurance mentioned is for the benefit of the Trust is not persuasive. The fact is that the Trust was obligated to pay the excess claims or to indemnify Bedding for the excess risk. Whether the money to make such payments came from excess Trust funds or from an insurance policy that benefited the Trust is irrelevant. It is the obligation to indemnify another for risk that is the hallmark of insurance, and that obligation was the Trust's. Therefore, we discern no error in the circuit court's finding that the Agreement is an insurance contract.

Scott, 404 S.W.3d at 876-77.

The appellants rely upon the decision of the United States Supreme Court in *Securities and Exchange Commission v. Variable Annuity Life Ins. Co. of America* [*VALIC*], 359 U.S. 65, 79 S.Ct. 618, 3 L.Ed.2d 640 (1959), to argue that, because the product in this case was a variable annuity, it was not an insurance contract.

> While all the States regulate 'annuities' under their 'insurance' laws, traditionally and customarily they have been fixed annuities, offering the annuitant specified and definite amounts beginning with a certain year of his or her

life. The standards for investment of funds underlying these annuities have been conservative. The variable annuity introduced two new features. First, premiums collected are invested to a greater degree in common stocks and other equities. Second, benefit payments vary with the success of the investment policy. The first variable annuity apparently appeared in this country about 1952 when New York created the College Retirement Equities Fund to provide annuities for teachers. It came into existence as a result of a search for a device that would avoid paying annuitants in depreciated dollars. The theory was that returns from investments in common stocks would over the long run tend to compensate for the mounting inflation. The holder of a variable annuity cannot look forward to a fixed monthly or yearly amount in his advancing years. It may be greater or less, depending on the wisdom of the investment policy. In some respects the variable annuity has the characteristics of the fixed and conventional annuity: payments are made periodically; they continue until the annuitant's death or in case other options are chosen until the end of a fixed term or until the death of the last of two persons; payments are made both from principal and income; and the amounts vary according to the age and sex of the annuitant. Moreover, actuarially both the fixed-dollar annuity and the variable annuity are calculated by identical principles. Each issuer assumes the risk of mortality from the moment the contract is issued. That risk is an actuarial prognostication that a certain number of annuitants will survive to specified ages. Even if a substantial number live beyond their predicted demise, the company issuing the annuity – whether it be fixed or variable – is obligated to make the annuity payments on the basis of the mortality prediction reflected in the contract. This is the mortality risk assumed both by respondents and by those who

issue fixed annuities. It is this feature, common to both, that respondents stress when they urge that this is basically an insurance device.

The difficulty is that, absent some guarantee of fixed income, the variable annuity places all the investment risks on the annuitant, none on the company. The holder gets only a pro rata share of what the portfolio of equity interests reflects – which may be a lot, a little, or nothing. We realize that life insurance is an evolving institution. Common knowledge tells us that the forms have greatly changed even in a generation. And we would not undertake to freeze the concepts of 'insurance' or 'annuity' into the mold they fitted when these Federal Acts were passed. But we conclude that the concept of 'insurance' involves some investment risk-taking on the part of the company. The risk of mortality, assumed here, gives these variable annuities an aspect of insurance. Yet it is apparent, not real; superficial, not substantial. In hard reality the issuer of a variable annuity that has no element of a fixed return assumes no true risk in the insurance sense. It is no answer to say that the risk of declining returns in times of depression is the reciprocal of the fixed-dollar annuitant's risk of loss of purchasing power when prices are high and gain of purchasing power when they are low. We deal with a more conventional concept of risk-bearing when we speak of 'insurance.' For in common understanding 'insurance' involves a guarantee that at least some fraction of the benefits will be payable in fixed amounts. See Spellacy v. American Life Ins. Ass'n, 144 Conn. 346, 354-355, 131 A.2d 834, 839; Couch, Cyclopedia of Insurance Law, Vol. 1, s 25; Richards, Law of Insurance, Vol. 1, s 27; Appleman, Insurance Law and Practice, Vol. 1, s 81. The companies that issue these annuities take the risk of failure. But

> they guarantee nothing to the annuitant except an interest in a portfolio of common stocks or other equities – an interest that has a ceiling but no floor. There is no true underwriting of risks, the one earmark of insurance as it has commonly been conceived of in popular understanding and usage.

VALIC, 359 U.S. at 69-73, 79 S.Ct. at 621-23 (footnotes omitted). The Supreme Court, the appellants stated, concluded that a variable annuity was not insurance even though it retained some aspects of insurance.

In *Securities and Exchange Commission v. United Benefit Life Insurance Company*, 387 U.S. 202, 87 S.Ct. 1557, 18 L.Ed.2d 673 (1967), cited by the appellants, the Supreme Court addressed whether a flexible fund annuity was a security or insurance product, concluding that it was not insurance based upon *VALIC*:

> 'Flexible Fund' arrangements require special modifications of state law, and are considered to appeal to the purchaser not on the usual insurance basis of stability and security but on the prospect of 'growth' through sound investment management. And while the guarantee of cash value based on net premiums reduces substantially the investment risk of the contract holder, the assumption of an investment risk cannot by itself create an insurance provision under the federal definition. Helvering v. Le Gierse, 312 U.S. 531, 542, 61 S.Ct. 646, 650, 85 L.Ed. 996. The basic difference between a contract which to some degree is insured and a contract of insurance must be recognized.

United Benefit, 387 U.S. at 211, 87 S.Ct. at 1562 (footnote omitted).

And the D.C. Circuit Court of Appeals more recently addressed the difference between a traditional fixed annuity and a fixed index annuity:

> A traditional fixed annuity is a contract issued by a life insurance company, under which the purchaser makes a series of premium payments to the insurer in exchange for a series of periodic payments from the insurer to the purchaser at agreed upon later dates. In a fixed annuity, the insurance company guarantees that the purchaser will earn a minimum rate of interest over time. Fixed annuities are subject to state insurance law regulation, and are exempt from federal securities laws. *See* [15 U.S.C. § 77c(a)(8)]. State insurance laws governing fixed annuity contracts require insurance companies to guarantee a minimum of the contract value after any costs and charges are applied. These state laws generally require the minimum guarantee be at least 87.5 percent of the premiums paid, accumulated at an annual interest rate of 1 to 3 percent. Indexed Annuities and Certain Other Insurance Contracts (*Final FIA Rule*), 74 Fed.Reg. 3138, 3141 (Jan. 16, 2009) (to be codified at 17 C.F.R. Parts 230 and 240). The laws also generally impose disclosure and suitability requirements, which vary from state to state.
>
> A fixed index annuity (FIA) is a hybrid financial product that combines some of the benefits of fixed annuities with the added earning potential of a security. Like traditional fixed annuities, FIAs are subject to state insurance laws, under which insurance companies must guarantee the same 87.5 percent of purchase payments. Unlike traditional fixed annuities, however, the purchaser's rate of return is not based upon a guaranteed interest rate. In FIAs the insurance company credits the purchaser with a return that is based on the performance of a securities index, such as the Dow Jones Industrial Average, Nasdaq 100 Index, or Standard & Poor's 500 Index. Depending on the performance of the securities index to which a particular FIA is tied, the return on an

> FIA might be much higher or lower than the guaranteed rate of return offered by a traditional fixed annuity. Due to the fact that the purchaser's actual return is linked to the performance of a securities index, however, the purchaser's return cannot be calculated until the end of the crediting period. Insurance companies typically apply an annual crediting period; that is, the index-linked interest of an FIA is typically calculated on an annual basis after each one-year period ends.

American Equity Inv. Life Ins. Co. v. S.E.C., 613 F.3d 166, 168 (D.C. Cir. 2010).

The *American Equity* Court examined both *VALIC* and *United Benefit* before holding:

> By their nature, FIAs "appeal to the purchaser not on the usual insurance basis of stability and security but on the prospect of 'growth' through sound investment management." *United Benefit*, 387 U.S. at 211, 87 S.Ct. 1557. An FIA is akin to an annuity contract with respect to its pay-in and guaranteed minimum value of purchase payment features. The interest return rate of an FIA, however, is decidedly more like a security in that the index-based return of an FIA is not known until the end of a crediting cycle, as the rate is based on the actual performance of a specified securities index during that period. Similar to an investor in securities, a purchaser of an FIA knows the level of annual return he will receive once the year is concluded and the index's value is compared with its value at the beginning of the year. In FIAs, as in securities, there is a variability in the potential return that results in a risk to the purchaser. By contrast, an annuity contract falling under Rule 151's exemption avoids this variability by guaranteeing the interest rate ahead of time. As these characteristics show, FIAs "involve considerations of investment not present in the conventional contract of insurance." *Id*. at 210, 87 S.Ct. 1557 (quotation omitted). Accordingly, the SEC's

> interpretation that an FIA does not constitute an "annuity contract" under § 3(a)(8) of the Act was reasonable.

American Equity, 613 F.3d at 174.

On the other hand, Gutzman contends that *VALIC* is not authoritative on the issue of the hybrid nature of a variable annuity and that the product sold to McGaughey in this case is an insurance product because it had fixed payments. She cites to *Patenaude*, *supra*, and *Lander*, *supra*, in support of this argument. Both of those cases addressed whether the McCarran-Ferguson Act precluded the Securities Litigation Uniform Standards Act (SLUSA) from applying to a variable annuity. The *Patenaude* Court began its analysis of the hybrid nature of the variable annuity by recognizing the holding in *VALIC*:

> [T]he sale of variable annuities has been subject to federal securities law for more than half a century, even when the variable annuities are sold by insurance companies. *See Variable Annuity Life Ins. Co. of Am.*, 359 U.S. at 70-72, 79 S.Ct. 618. Thus, Congress has consistently indicated its intent, particularly with the passage of SLUSA, to displace state regulation insofar as it relates to the marketing of the securities component of variable annuities.

Patenaude, 290 F.3d at 1027. But the Court went on to state:

> However, this does not end the analysis because tax-deferred variable annuities are "hybrid" products, that is, they retain some aspects of both a security and an insurance product. To understand the interplay, we must deconstruct the product. "An annuity is a contract between a seller (usually an insurance company) and a buyer (usually an individual, also referred to as the

'annuitant') whereby the annuitant purchases the right to receive a stream of periodic payments to be paid either for a fixed term or for the life of the purchaser or other designated beneficiary." *Lander*, 251 F.3d at 104. Traditional annuities, or annuities in which payment begins immediately or soon after purchase and the contract specifies the amount of each payment, are "typically thought of as insurance products because the annuitant receives a guaranteed stream of income for life, and the insurer assumes and spreads the 'mortality risk' of the annuity – the risk that the annuitant will live longer than expected, thereby receiving benefits that exceed the amount paid to the seller of the policy." *Id*.

In contrast, a deferred annuity is an accumulation product. *Id*. at 104-05. The purchaser invests money and allows the value of the account to grow and then later on draws down the value of the account. *Id*. at 104. In a fixed deferred annuity, the purchaser receives from the insurer an interest rate on the amount of premiums invested by the purchaser. In a variable deferred annuity, the purchaser is not guaranteed a particular rate of return; instead, the purchaser invests in one or more professionally managed diversified investment products, offered through "separate accounts" of the insurance companies, and receives a rate of return that varies depending upon the success of the underlying investment. *Id*. at 105. Although deferred annuities have an investment component, they typically retain two insurance features: a guarantee of monthly payments for life and a benefit that is payable if the annuitant dies before the payout begins. *Id*. Thus, "[v]ariable annuities are typically characterized as 'hybrid products,' possessing characteristics of both insurance products and investment securities." *Id*.

As hybrid products, variable annuities are properly subjects of hybrid regulation. There is nothing inappropriate or inconsistent about the securities component being subject to federal securities regulation

> and the insurance aspects being subject to state regulation. For that reason, nothing in SLUSA displaces state insurance regulation, nor "invalidate[s], impair[s], or supersede[s] any law enacted by any State for the purpose of regulating the business of insurance." 15 U.S.C. § 1012(b). Rather, SLUSA's purpose is the preemption of private securities class action lawsuits, not the displacement of state insurance regulation. Indeed, SLUSA expressly preserves state governmental enforcement powers. 15 U.S.C. § 77p(e). Thus, under SLUSA, "[s]tate authorities may continue to enforce existing or new securities and insurance regulations concerning the sale of variable annuities in precisely the same manner as they have in the past." *Lander*, 251 F.3d at 118. Indeed, the only actions that SLUSA preempts are specific types of private party securities class actions based upon state statutory or common law.

Patenaude, 290 F.3d at 1027-28 (footnote omitted).

The 2nd Circuit Court of Appeals, in *Lander*, *supra*, cited in *Patenaude*, stated that it was "reluctant to hold categorically that for the purposes of the McCarran-Ferguson Act, variable annuities are not the business of insurance[,]" 251 F.3d at 116, noting that they are hybrid products and the acknowledgement in *VALIC* "that variable annuities possess at least some aspects of insurance" and that they "are not solely securities." *Id.*

The appellants point to the language on the new account form dated December 10, 2009, to argue that McGaughey was purchasing a variable product, not a fixed one. Page 2 of the form includes a check mark next to "Variable." On page 7 of the Jackson Life Fixed and Variable Annuity Application dated the same

day, McGaughey signed the Client Acknowledgements section, which included the following acknowledgement:

> 3. I (We) understand that the Contract I (We) have applied for is variable and employs the use of a separate account. I (We) also understand that the annuity benefits, death benefit values, and withdrawal values, if any, when based on the investment experience of an Investment Division in the separate account of Jackson are variable and may be increased or decreased, and the dollar amounts are not guaranteed by Jackson or any other insurance company, the United States government or any state government, the FDIC, Federal Reserve Board or any other federal or state agency. I (We) understand that, except for funds allocated to the Contract's Fixed Account Option, I (We) will bear all risk under the Contract.

And her investment allocations on page 5 did not include a fixed account option.

Gutzman counters that the current product dated December 14, 2015, and signed by McGaughey on December 24, 2015, related to the income option election. It shows that the payments were to be paid on a monthly basis beginning January 1, 2016, and the method was via a fixed annuitization. The form explained that meant: "Payments will remain level for the duration of the payment period." Quarterly statements detailed payments in the amount of $9,695.90 were made each month from the "Fixed Account" portfolio. Based upon these documents, Gutzman contends that the product was fixed, not variable. We agree.

While the various documents and contracts filed in this matter complicate our review, and while we agree with the appellants that Gutzman did

not provide the first page of one of the documents cited in the above paragraph, we are convinced that the circuit court properly held that the product at issue in this case is an insurance product rather than a security product, meaning that the arbitration clause cannot be enforced. We are persuaded by the documents Gutzman filed that the product at issue is for insurance based upon the description of the portfolio as a fixed account and the regular payments of the same amount, which establish that this was a fixed product and consistent with an insurance product. Therefore, we hold that the product was a fixed annuity and that the circuit court did not err in denying the appellants' motion to compel arbitration.

For the foregoing reasons, the order of the Fayette Circuit Court is affirmed.

ALL CONCUR.

BRIEFS FOR APPELLANTS:

Andrew R. Smith
Lexington, Kentucky

Eric Gribbin
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BRIEF FOR APPELLEE BRENDA GUTZMAN:

Thomas K. Herren
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