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IN THE UNITED STATES DISTRICT COURT  
FOR THE DISTRICT OF ARIZONA

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Jonah Shacknai, et al.,

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No. CV-08-01025-PHX-FJM

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Plaintiffs,

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**ORDER**

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vs.

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John Charles Mathieson, et al.,

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Defendants.

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Plaintiffs Jonah Shacknai and three trusts bring this action against defendants John Mathieson, Sherrie Sucher-Mathieson, and three Merrill Lynch entities asserting tort and contract claims arising out of the sale of life insurance. The court has before it defendants' unsealed and sealed motions for summary judgment (docs. 149 & 168), plaintiffs' response (doc. 180), and defendants' reply (doc. 181).

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**I.**

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In late 2003, Shacknai was in the market for a substantial amount of life insurance for estate planning purposes. His Merrill Lynch financial advisor introduced him to Mathieson, a life insurance specialist with Merrill Lynch Insurance Group. During a short initial meeting around December 5, 2003, Shacknai and Mathieson discussed using a premium financing arrangement to purchase life insurance. Premium financing is supposed to provide tax and liquidity advantages by using funds borrowed against potentially illiquid assets to front load

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1 a large insurance policy. The objective is to accumulate a substantial cash value quickly in  
2 order for the returns on the cash value to be sufficient to pay the periodic insurance charges  
3 for the policy and interest payments on the loan. A second, much smaller, life insurance  
4 policy is sometimes used for withdrawals to pay interest on the loan during the early years  
5 while the cash value of the larger policy is building. When paired with a trust as the owner  
6 and beneficiary, a successful premium-financed life insurance policy can exist outside of the  
7 insured's estate without requiring substantial liquidity or exchanges potentially subject to gift  
8 taxes to fund it. On the death of the insured, the principal on the loan is repaid out of the  
9 death benefit, leaving the balance for an insured's children and/or to pay estate taxes. The  
10 success of premium financing depends, in part, on the difference between the interest rate on  
11 the loan, which is a factor of the short-term interest rate environment, and the crediting rate  
12 on the policy's cash value, which is determined by the insurer's return on longer-term  
13 investments. This is the kind of tax avoidance scheme that causes the public to be resentful  
14 of wealthy persons and their financial advisors.

15         During a second meeting on December 8, 2003, Shacknai and Mathieson spent about  
16 an hour going over premium financing using several generic illustrations from Institutional  
17 Marketing Consultants, Inc., a firm Mathieson collaborated with to structure such  
18 transactions. Defendants allege that they also reviewed an insurance illustration from Pacific  
19 Life. Drawing all reasonable inferences in favor of plaintiffs as non-movants, Mathieson  
20 described his product as bulletproof and self-sustaining with very little risk. According to  
21 Mathieson, it was low risk because long-term rates historically exceed short-term rates and  
22 they rarely invert because they float in the same market. Unsure of Mathieson's oral  
23 representations, Shacknai requested a personal letter disclosing the risks involved with  
24 premium financing.

25         The next day, Shacknai filled out an application and signed two standardized  
26 disclosure statements. The first was from Pacific Life as the potential insurer. It explained  
27 that structuring illustrations like the ones Shacknai considered contain non-guaranteed  
28 elements and need to be understood in conjunction with an insurance illustration. The second

1 was specific to structuring illustrations and stated, in part, that the time during which the cash  
2 value would be able to service the loan interest was not guaranteed and it depended on the  
3 actual interest rate charged each year and the crediting rate. It also disclosed that the rates  
4 were not guaranteed.

5         Shacknai moved forward with the transaction. In mid-December 2003, structuring  
6 illustrations specific to his requirements were generated, one of which he eventually signed.  
7 The final package took the form of two Pacific Life policies with face amounts of \$40  
8 million and \$2.8 million, an initial \$3.3 million loan from A.I. Credit Corp. (“AIC”), and  
9 security agreements to pledge the policies themselves and \$2 million in securities from one  
10 of Shacknai’s trusts as collateral for the loan. A new trust was created to own the policies  
11 and be obligated on the loan. The plan was to borrow close to \$13.8 million more from AIC  
12 over the next six years to invest in the main policy. The policy contracts, the promissory  
13 note, and the security agreements were entered into in late January and early February 2004.  
14 They all included merger clauses. The annual crediting rate on the policies’ cash values had  
15 a current rate of 6.70%, representing 4.00% as a guaranteed minimum with excess interest  
16 credited depending on market conditions. The annual interest rate on the note was 3.38% for  
17 the first year and the 1-year London Interbank Offered Rate plus 2.00% adjusted annually  
18 thereafter.

19         Around the same time, Shacknai apparently insisted on receiving the disclosure letter  
20 he had requested in December. Mathieson responded by sending Shacknai a letter dated  
21 February 5, 2004 which purported to explain the risks of premium financing. It disclosed  
22 that poor insurer performance could lead to additional financial outlay. It also arguably  
23 implied that the risk from an inversion of the short- and long-term rates was only the posting  
24 of additional collateral and not the possibility of additional financial outlay, and only if the  
25 inversion were to last over ten years. The trust acknowledged delivery of the policies in  
26 March 2004 and the transaction closed.

27         In 2007, the interest rate on the loan rose to 7.04% and the crediting rate on the  
28 policies fell to 5.60%. In January 2008, the trust was required to pay \$572,136.71 to AIC for

1 interest not otherwise paid through withdrawals from the policies' cash values. It did not  
2 make the payment and defaulted on the loan. In September 2008, AIC surrendered the  
3 policies and liquidated the securities posted as collateral.

4 Plaintiffs' complaint includes tort and statutory claims for negligence, negligent  
5 misrepresentation, negligent hiring, training and supervision, consumer fraud, and insurance  
6 fraud. It also alleges claims for breach of an oral contract and the implied covenant of good  
7 faith and fair dealing. Defendants now move for summary judgment or partial summary  
8 judgment on all of the claims.

## 9 II.

10 Defendants challenge plaintiffs' claims on six grounds. They contend that the  
11 heightened standard for negligent misrepresentation precludes the general negligence claim  
12 and the economic loss rule bars the non-statutory tort claims. They also maintain that  
13 plaintiffs can show neither statements about present facts to support claims for negligent  
14 misrepresentation, insurance fraud, or consumer fraud, nor justifiable reliance to support  
15 claims for negligent misrepresentation or insurance fraud. Moreover, they contend that  
16 plaintiffs' allegations do not state a claim for insurance fraud. Finally, defendants assert that  
17 the parol evidence rule bars both of plaintiffs' contract claims.

18 A claim for negligence against a provider of professional information concerning  
19 representations or omissions must satisfy requirements beyond a general claim for  
20 negligence. Kuehn v. Stanley, 208 Ariz. 124, 128, 91 P.3d 346, 350 (Ct. App. 2004). Thus,  
21 one cannot bring a separate claim for negligence where negligent misrepresentation is the  
22 proper claim. Id. Plaintiffs concede that their negligence claim is no longer appropriate.  
23 Therefore, we grant defendants' motions for summary judgment on plaintiffs' negligence  
24 claim.

25 Defendants contend that the economic loss rule bars plaintiffs' claims for negligent  
26 misrepresentation and negligent hiring, training, and supervision because plaintiffs also seek  
27 to recover the same economic damages under a purported oral contract. Under very limited  
28 circumstances, the economic loss rule precludes recovery in tort for purely economic losses

1 in order to maintain the distinction between tort and contract. While federal courts have  
2 applied the doctrine more broadly, Arizona state appellate courts have not extended it beyond  
3 the contexts of products liability and construction defects. Flagstaff Affordable Hous. Ltd.  
4 P'ship v. Design Alliance, Inc., 212 P.3d 125, 128 (Ariz. Ct. App. 2009); Evans v. Singer,  
5 518 F. Supp. 2d 1134, 1142 (D. Ariz. 2007). The Arizona Court of Appeals recently  
6 explored the limits of the economic loss rule. The court distinguished architectural design  
7 from construction defects and held that the economic loss rule does not apply to professional  
8 negligence claims against architects because they arise from duties implied by law  
9 independently of any contract. Flagstaff Affordable Hous., 212 P.3d at 129. In deciding  
10 whether the economic loss rule applies, the court urged the use of the same three factors in  
11 both products liability and construction defects cases. Valley Forge Ins. Co. v. Sam's  
12 Plumbing, LLC, 220 Ariz. 512, 207 P.3d 765 (Ct. App. 2009); Hughes Custom Bldg., LLC  
13 v. Davey, 212 P.3d 865 (Ariz. Ct. App. 2009). This analysis was originally formulated by  
14 the Arizona Supreme Court in the context of products liability. Salt River Agric.  
15 Improvement & Power Dist. v. Westinghouse Elec. Corp., 143 Ariz. 368, 376-79, 694 P.2d  
16 198, 206-09 (1984), abrogated on other grounds by Phelps v. Firebird Raceway, Inc., 210  
17 Ariz. 403, 111 P.3d 1003 (2005). The goal is to determine “whether the claim brought  
18 properly sounds in tort or in contract” using the prescribed factors: the nature of the defect  
19 causing the loss, the manner in which the loss occurred, and the type of loss. Hughes Custom  
20 Bldg., 212 P.3d at 870. The first factor turns on whether the defect is unreasonably  
21 dangerous, the second on whether the loss was accidental or gradual, and the third on  
22 whether the loss was economic or physical. Id. at 870-72.

23 Thus, the issue is whether plaintiffs’ claims properly sound in tort or in contract based  
24 on a case-by-case analysis of factors relevant to defects but not insurance. Indeed, the recent  
25 affirmation of the three-factor analysis suggests that caution is warranted when considering  
26 the applicability of the economic loss rule in broader contexts. We are persuaded that the  
27 Arizona Supreme Court would not apply the economic loss rule in this action. Unlike many  
28 claims in tort, negligent misrepresentation is designed to allow recovery of purely economic

1 losses. The insurance field is a regulated industry traditionally subject to a backdrop of tort  
2 liability. And there is little indication that Shacknai and Mathieson allocated the risks  
3 involved with Mathieson's representations through contract such that the parties should be  
4 left to the benefits of their bargain. Accordingly, we conclude that the economic loss rule  
5 does not bar plaintiffs' claims because they properly sound in tort.

6 Next, defendants contend that plaintiffs' claims for negligent misrepresentation,  
7 consumer fraud, and insurance fraud fail as a matter of law because plaintiffs' allegations  
8 concern non-actionable statements about future events. Claims for negligent  
9 misrepresentation and fraud must be based on statements about present facts. McAlister v.  
10 Citibank, 171 Ariz. 207, 215, 829 P.2d 1253, 1261 (Ct. App. 1992). Plaintiffs concede that  
11 Mathieson's predictions about the interaction of interest rates concerned future events.  
12 Instead, they base their claims on Mathieson's risk representations in the February 5, 2004  
13 disclosure letter, including an implication that additional financial outlay was not a risk  
14 associated with inverted interest rates. A reasonable trier of fact could find that Mathieson  
15 misrepresented or omitted then-present facts concerning the risks involved with premium  
16 financing. Therefore, we deny defendants' motions for summary judgment to the extent of  
17 this contention.

18 Defendants also maintain that plaintiffs' negligent misrepresentation and insurance  
19 fraud claims fail because plaintiffs cannot show justifiable reliance. Whether one can rely  
20 on representations justifiably depends on one's own information and intelligence. St.  
21 Joseph's Hosp. & Med. Ctr. v. Reserve Life Ins. Co., 154 Ariz. 307, 316, 742 P.2d 808, 817  
22 (1987). Defendants contend that the illustrations and standardized disclosure statements that  
23 Shacknai considered, the contracts entered into at his direction, and his sophistication as a  
24 law school graduate and corporate executive preclude a finding of justifiable reliance on  
25 Mathieson's alleged oral statements or on the disclosure letter. Plaintiffs concede that  
26 Shacknai did not rely on Mathieson's oral representations and that some of the differences  
27 between Mathieson's statements and the documents put him on inquiry notice. However,  
28 they assert that a reasonable trier of fact could find that Shacknai justifiably relied on the

1 result of his further inquiry, the disclosure letter, which came at a critical juncture for the  
2 closing of the transaction and contained a material misrepresentation or omission. We agree.  
3 Thus, defendants' motions for summary judgment are denied insofar as they challenge  
4 plaintiffs' ability to show justifiable reliance.

5 Arizona's insurance fraud statute prohibits statements misrepresenting the benefits or  
6 advantages of insurance policies. A.R.S. § 20-443(A)(1). Defendants contend that plaintiffs'  
7 allegations do not state a claim for insurance fraud because they involve the financing of the  
8 policies and not the policies themselves. The policies involved in this action cannot be  
9 divorced so easily from their financing. The primary function of the smaller policy was to  
10 finance the interest payments on the loan during the early years of the premium financing  
11 arrangement. Any statements made concerning the benefits or advantages of premium  
12 financing were statements about the benefits or advantages of the subject policies. Therefore,  
13 we deny defendants' motions for summary judgment on plaintiffs' claim for insurance fraud.

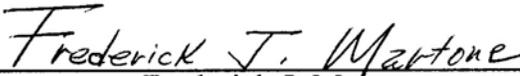
14 Finally, defendants contend that plaintiffs' contract claims are barred by the parol  
15 evidence rule. Plaintiffs allege that they formed an oral agreement with the Merrill Lynch  
16 defendants, AIC, and Pacific Life under which plaintiffs would never have to pay out-of-  
17 pocket for loan interest or insurance premiums. They offer Mathieson's oral representations  
18 to Shacknai as evidence of this contract. Defendants assert that such a contract would  
19 directly contradict the obligations set out in the AIC promissory note and the Pacific Life  
20 policies. Such a contract would also directly contradict the disclosure letter which plaintiffs  
21 claim is consistent with Mathieson's oral representations. It states that additional financial  
22 outlay by Shacknai might be required were the insurer to perform poorly for an extended  
23 period.

24 The parties disagree on whether New York or Arizona law applies to the note and the  
25 policies to determine integration and the applicable parol evidence rule. However, they agree  
26 that New York law is less accommodating to the preliminary consideration of parol evidence  
27 to determine the parties' intent and the extent of integration. Assuming, without deciding,  
28 that plaintiffs are correct and Arizona law applies, we consider plaintiffs' evidence of the

1 parties' intent and find that it is inadmissible because it contradicts the integrated note and  
2 the integrated policies. See Taylor v. State Farm Mut. Auto Ins. Co., 175 Ariz. 148, 153, 854  
3 P.2d 1134, 1139 (1993). Because plaintiffs' evidence of an oral contract is inadmissible,  
4 their breach of contract and breach of the implied covenant of good faith and fair dealing  
5 claims fail. We grant defendants' motions for summary judgment on plaintiffs' contract  
6 claims.

7 **IT IS THEREFORE ORDERED GRANTING IN PART and DENYING IN**  
8 **PART** defendants' unsealed and sealed motions for summary judgment (docs. 149 & 168).  
9 They are granted on plaintiffs' claims for negligence, breach of contract, and breach of the  
10 implied covenant of good faith and fair dealing. They are denied on plaintiffs' claims for  
11 negligent misrepresentation, negligent hiring, training, and supervision, consumer fraud, and  
12 insurance fraud.

13 DATED this 2<sup>nd</sup> day of December, 2009.

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16 Frederick J. Martone  
17 United States District Judge  
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