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LIFE INSURANCE INDUSTRY
LEGAL ISSUES AND DEVELOPMENTS
FROM CARLTON FIELDS JORDEN BURT, P.A.

VOLUME II, JULY 2016

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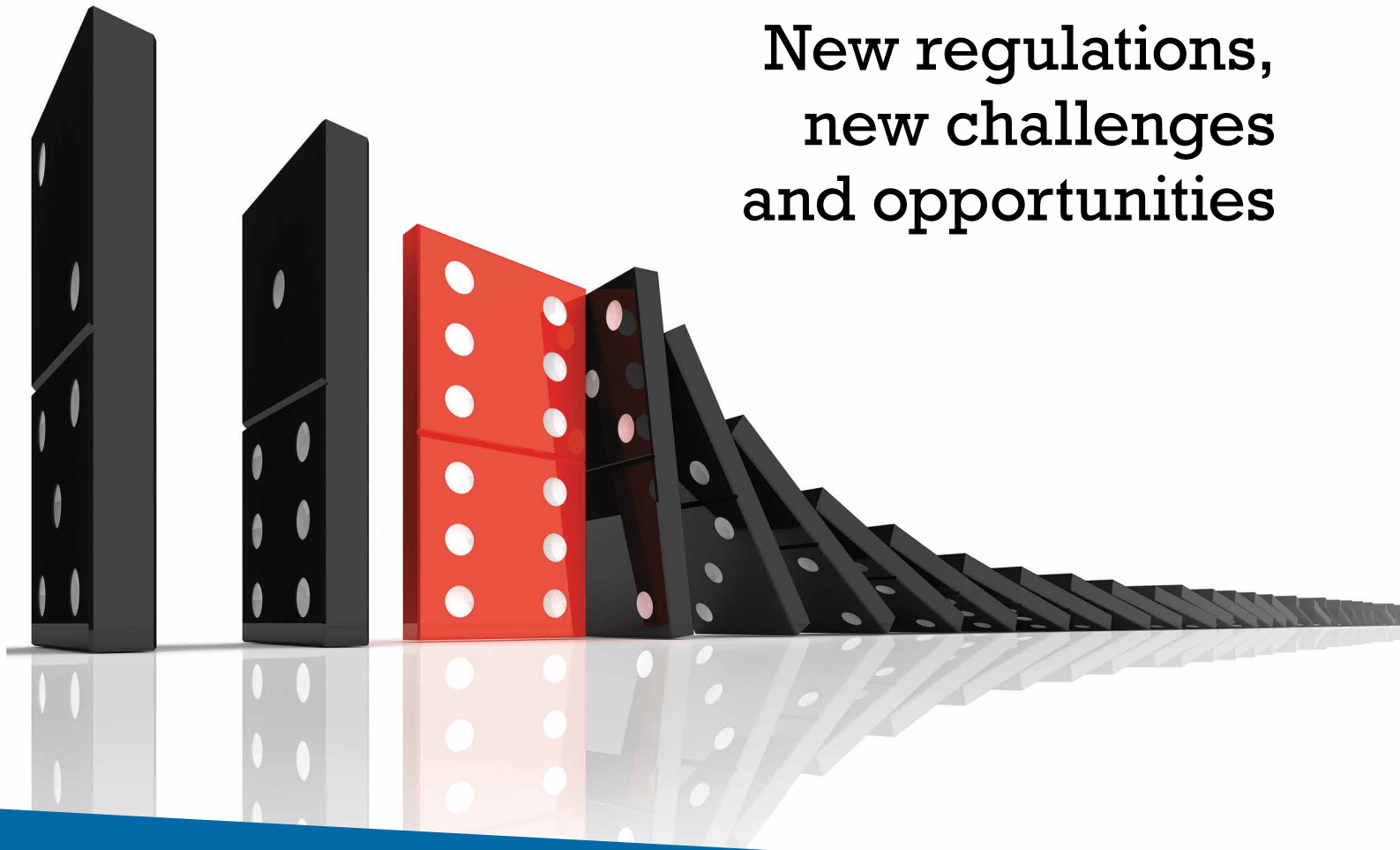


CARLTON FIELDS JORDEN BURT

TABLE OF CONTENTS

EXPECTFOCUS® LIFE INSURANCE, VOLUME II, JULY 2016

EXPECTFOCUS® is a quarterly review of developments in the insurance and financial services industry, provided on a complimentary basis to clients and friends of Carlton Fields Jorden Burt, P.A.

EXECUTIVE EDITOR
Josephine Cicchetti

EDITOR
Christina Calhoun

PRODUCTION EDITOR
Lauryn Oser

COPY EDITOR
Adriana Gardella

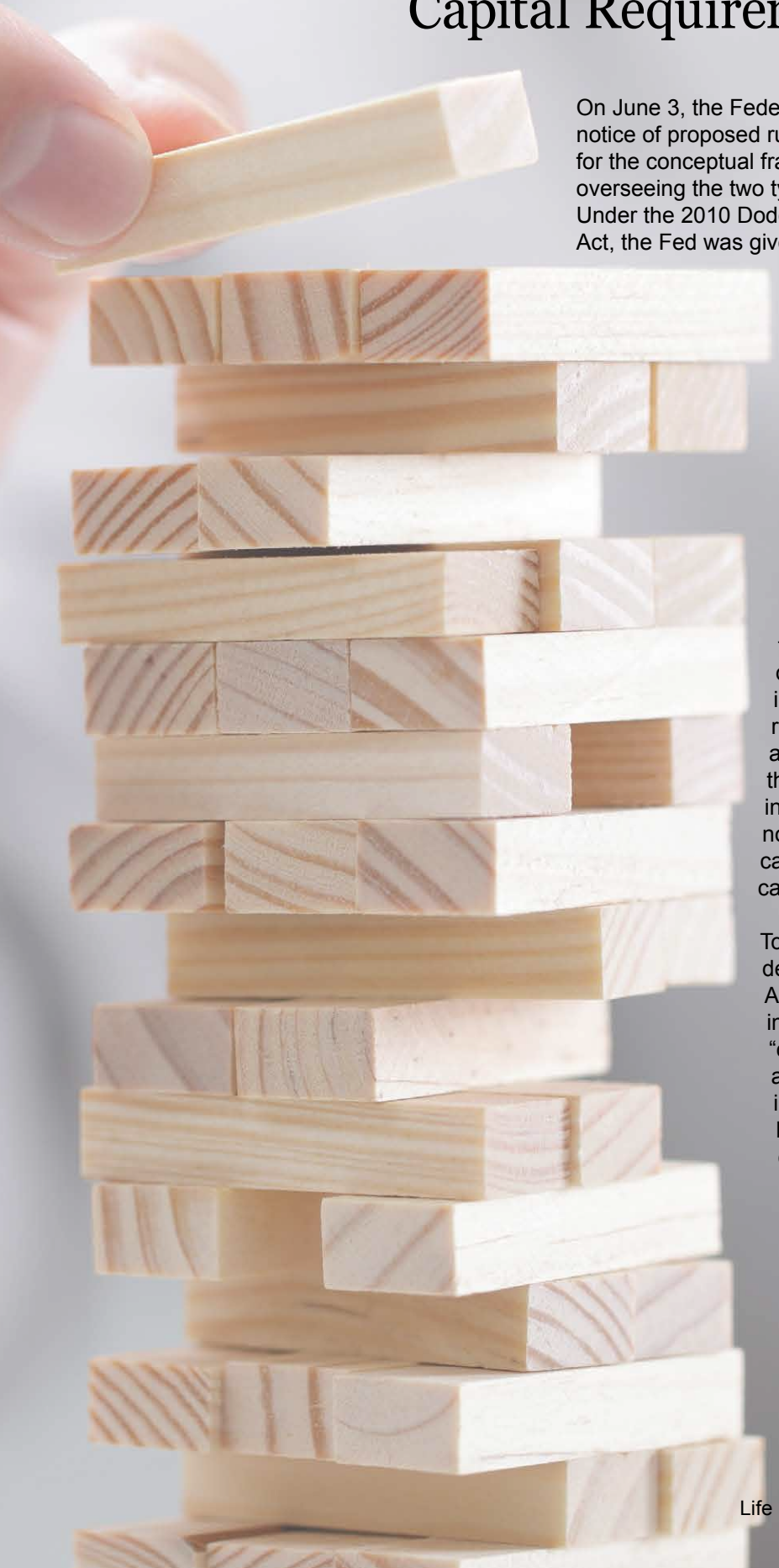
LAYOUT
Frances Liebold

SUBSCRIPTIONS

Changes in address or requests for subscription information should be submitted to: **Lauryn Oser, leoser@carltonfields.com**.

Fed Takes First Steps Toward Setting Capital Requirements for Some Insurers

BY ROBERT B. SHAPIRO



On June 3, the Federal Reserve Board (the "Fed") released an advance notice of proposed rulemaking (ANPR) and began soliciting comments for the conceptual framework for capital standards that it will use when overseeing the two types of insurers for which it has supervisory authority. Under the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act, the Fed was given regulatory authority over insurers that own federally insured banks or thrift institutions and those the Financial Stability Oversight Council (FSOC) designates as systemically important insurers (SIIs).

The ANPR closely follows the outline of the Fed's intentions regarding the financial regulation of such insurers. These intentions were first articulated in a May 20 speech at the International Insurance Forum by Daniel Tarullo, a member of the Fed's Board of Governors. The Fed intends to use different capital requirement approaches for the two types of insurers.

For insurers that own banks or thrift institutions, the Fed would use a "building blocks approach" to determine required capital. Under this approach, insurers would in most instances be able to use the regulatory capital rules that the relevant regulator already applies to each affiliate. In an insurer's case, the capital requirements would be those of the state insurance regulator or, in a non-U.S. insurer's case, the non-U.S. insurance regulator. Each group's aggregate capital would generally be the sum of the individual capital requirements for each member.

To determine required capital standards for insurers designated as SIIs—Prudential Financial, Inc. and American International Group are currently the only insurers designated as SIIs—the Fed would use a "consolidated approach" based on generally accepted accounting principles but modified due to the difference in accounting standards under which insurers operate. For SIIs, the consolidated approach would categorize an entire insurance firm's assets and insurance liabilities into risk segments, apply appropriate risk factors to each segment at the consolidated level, and set a minimum ratio of required capital.

The regulatory capital required of SIIs and bank holding companies would appear to be similar. Though, as Tarullo said in his speech "the CA [consolidated approach] would use risk weights or risk factors that are more appropriate for the longer-term nature of most insurance liabilities."

New Wave of COI Rate Increase Lawsuits Hits the Industry

BY PAUL WILLIAMS, SHAUNDA PATTERSON-STRACHAN & STEPHEN JORDEN

Historically, increases to cost of insurance (COI) rates on universal life (UL) policies have been met with legal challenges from policyholders, and sometimes, regulatory opposition spurred by policyholder complaints. The most common refrain is that, on top of the contract's guaranteed maximum rates, express or implied contractual limitations serve as a check on discretion, prohibiting the insurer from considering factors other than mortality experience. While there have been multiple waves of such litigation, these suits have had mixed outcomes. Judicial rulings are not always easily reconciled as to contract interpretation issues.

However, recent developments have led to a potentially more favorable environment for insurers. For example, many insurers have, over time, developed contracts that more explicitly reserve discretion to consider a variety of financial and actuarial factors in setting and changing COI rates. Also, in the last few years, courts have issued several decisions favorable to the insurer on key contract interpretation issues.

Against this backdrop, multiple insurers that experienced changes in future expectations as to pricing assumptions announced COI rate increases in the latter half of 2015 on blocks of their UL policies. Not surprisingly, given the litigious history surrounding such rate increases, in the first half of 2016 – following prominent press coverage and intense lobbying of state regulators by life settlement industry participants and consumer groups – at least eight lawsuits challenging such rate increases have been filed. Putative class action suits filed against AXA Equitable and Banner Life Insurance Company help illustrate the plaintiffs' different approaches, and highlight the issues—some familiar, some new—with which the parties and courts will likely grapple for years to come.

The two complaints filed against AXA represent a relatively recent phenomenon: COI rate challenges by life settlement investors. In both *Brach Family Foundation* and *Cartolano*, brought in federal courts in New York and Florida, respectively, the plaintiffs allege that AXA's COI rate increases were "unlawful," partly because they allegedly target owners who minimize their premium payments. Both actions incorporate the life settlement industry's myopic view of the flexible nature of UL policies: that they allow policyholders to minimally fund their policies and keep policy values low. Generally, however, the causes of action asserted in the AXA suits are consistent with those seen in COI rate challenges through the years. Thus, in *Cartolano*, in addition to a breach of contract claim, the complaint asserts a claim for declaratory judgment, and alleges that AXA breached the implied covenant of good faith and fair dealing. In addition to an alleged contractual breach, *Brach* advances a misrepresentation theory, claiming that AXA's illustrations were materially misleading in that they relied on overly aggressive pricing assumptions. While misrepresentation theories have been asserted in other COI suits, the plaintiff's focus on illustrations is novel in this setting.

But while the plaintiffs in *Dickman v. Banner*, filed in federal court in Maryland, assert causes of action that are relatively common in COI suits (breach of contract, unjust enrichment, conversion, and fraud), the suit also has more unfamiliar elements. First, plaintiffs attempt to tie their COI rate increase challenge to captive reinsurance – or so-called "shadow insurance"– transactions, claiming that both evince an attempt to "take U.S. policyholder funds and send them to [Banner's parent], ultimately to benefit shareholders." Thus plaintiffs characterize the COI rate increase as a "raid" on policyholder account values. These shadow insurance allegations are seemingly unrelated to plaintiffs' claims or damages, however. Rather, their inclusion appears aimed at enhancing the overall appearance of wrongdoing. And unlike the investor plaintiffs suing AXA, who decry the alleged deprivation of their right to minimally fund their contracts, the plaintiffs in *Dickman* allege

Rate increases are not the only COI-related activities generating litigation. Since the end of 2015, at least four suits claiming breach of contract for the insurer's *failure to lower COI rates* in the face of allegedly improved mortality statistics have been filed. These suits also challenge the insurer's initial COI rate-setting methodology.

they sought to pay *excess* premium payments hoping to *build* the policies' cash value, but were "lull[ed]" into continuing these excess payments via, *inter alia*, policyholder communications stating that the policies were performing as marketed.

The central battleground for any COI rate increase challenge is the interpretation of the terms of the COI rate provision involved. The AXA policies quoted in the complaint list several factors: "expenses, mortality, policy and contract claims, taxes, investment income, and lapse," as well as the "procedure and standards on file" with the insurance department. Banner's policies make no explicit reference to any factors – neither setting forth one, like mortality, or a laundry list; rather, they simply state that COI rates will be "based on our expectation as to future experience." Thus, both AXA's and Banner's contracts appear to provide the insurers with discretion to consider factors other than mortality in setting and modifying COI rates – which should demand more creative arguments by the plaintiff's counsel for implying limitations on the insurer's discretion.

Yet the *Cartolano* and *Brach* plaintiffs follow the usual path of plaintiffs in COI cases in contesting that AXA's increases were validly based on such factors as mortality or investment income. For example, plaintiffs rely on general mortality statistics to argue that mortality had actually *improved*, hoping to undermine the validity of AXA's own mortality expectations that the opposite would occur. The *Dickman* plaintiffs, facing a broad "expectation[s] as to future experience" clause, seek to cast Banner's asserted changed expectations as, essentially, a "bait and switch." They contended that the pessimistic expectations were concealed for years with overly optimistic pronouncements as to future experience expectations, which in turn acted as a kind of fraudulent inducement to policyholders to purchase the policies and pay their excess premiums.

The contracts at issue in the AXA and Banner lawsuits, respectively, also contain clauses prohibiting unfair discrimination among policyholders in the same class, and provide that the rates will "apply to all persons of the same class." While no such challenge is directed to Banner, the AXA suits allege that the insurer improperly determined a "class" based on funding level in order to target policyholders who minimally funded their policies for a COI increase. The *Brach* complaint doubles down on this contention, implicating the nondiscrimination provision, as well as the contract's "standards on file" provision. According to the plaintiff, the principle of nondiscrimination is a "standard on file" with the insurance departments of New York and other states.

AXA moved to dismiss the amended complaints in *Brach* and *Cartolano*, and Banner moved to dismiss *Dickman*. Among other things, these challenges to the sufficiency of the complaints could test the influence of recent rulings favorable to the industry. For example, *Brach* is pending in a forum that already decided an insurer may base COI rate increases on policy funding levels under a contract's "investment earnings" factor because policy values "are a logical thing to consider when predicting expected investment earnings" (*Fleisher v. Phoenix Life Ins. Co.*).*

*Carlton Fields Jorden Burt represented the insurer in this matter.

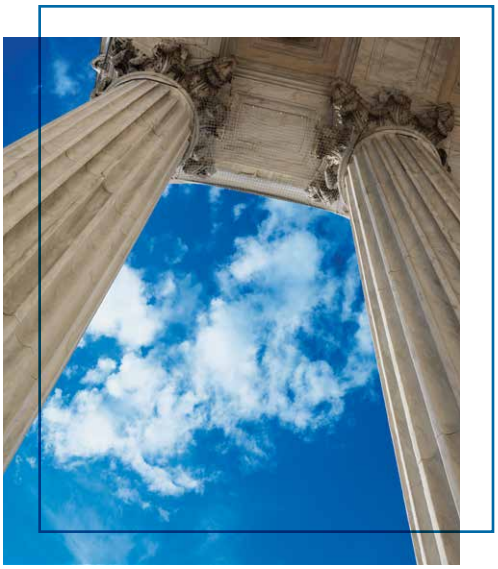
The authors would like to acknowledge the contributions of Thomas Rucker, summer associate from George Mason University, in the preparation of the article.

STOLI Policies Cancelled, Insurers Retain Premium

BY ROLLIE GOSS

Two federal appellate courts have affirmed, on different grounds, the cancellation of large life insurance policies that were alleged to be stranger originated life insurance (STOLI), permitting the issuing insurers to retain the premium paid for the policies.

In *Ohio National Life Assurance Corp. v. Davis*, the court affirmed the district court's ruling that a policy was STOLI, illegal, and void *ab initio* under Illinois law. The court found the policy, which was owned by a trust, was used "to hoodwink Ohio National." The applicants never paid any amount and the policy was, from the beginning, controlled by third-parties that intended to sell it to investors. The insureds were "the defendants' puppets and the policies were bets by strangers on the insureds' longevity," the court said. Declining to order the return of premium paid, the court followed the general rule of leaving



the parties where they placed themselves with respect to an illegal contract, but also affirmed summary judgment in favor of the insurer on a civil conspiracy claim under which it recovered the commissions it paid and its costs and attorneys' fees in obtaining a declaration that the policy was illegal.

In *PHL Variable Ins. Co. v. Sheldon Hathaway Family Ins. Trust*, the court found a policy on an elderly insured with an initial premium of $200,000 fit the STOLI model. All premiums were financed, and the policy was pledged as collateral for the premium loan. However, the policy was cancelled on summary judgment, due to a material misrepresentation of the applicant's net worth in the application, which was relied on by the insurer. Rejecting claims that the insurer had waived the right to rescind, the court affirmed the insurer's retention of the premium paid to return the insurer to the position it was in prior to the policy's issuance, since the commissions paid exceeded the premium paid.

SEC SEEKS FUND RESPONSES TO DISTRIBUTION-IN-GUISE GUIDANCE

BY ED ZAHAREWICZ

Since at least March 2016, SEC examiners have reportedly been checking whether mutual fund firms are complying with the SEC staff's recent guidance on "distribution-in-guise."

The guidance suggests that fund boards, investment advisers, and other relevant service providers consider assuming what some regard as significant new responsibilities. The guidance seeks principally to ensure that so-called "sub-accounting fees," which funds pay to intermediaries for shareholder and recordkeeping services, are not being used directly or indirectly to pay for distribution without complying with the generally-applicable legal requirement that fund distribution payments be covered by a "Rule 12b-1 plan." According to the guidance, regardless of whether a fund has a Rule 12b-1 plan, "the fund should have adequate policies and procedures for reviewing and identifying any payments that may be for distribution-related services that are not paid through the plan."

With the ink barely dry on the guidance, which was published in January, the staff's seeming impatience surprises some. Their reaction results from the significant nature of the guidance, plus the fact that the guidance mostly just identifies procedures that funds and their service providers *could* consider given their own particular circumstances, instead of prescribing specific procedures that funds should generally adopt. This, in turn, also raises a question as to whether the staff is inappropriately treating any aspects of the guidance as a regulation without the benefit of public comment.

Nonetheless, the staff is at least clearly signaling its expectations that registrants and chief compliance officers should be well on their way to completing, if they have not already, the task of assessing their exposure to potential distribution-in-guise issues and implementing reasonably-designed compliance controls in light of the guidance.

Life Policy Summaries/Narratives

An NAIC working group is considering how to revise provisions in its model regulations governing the content of the *policy summary* required in life insurance policy illustrations and the *policy narrative* that must be provided to purchasers where policy illustrations are not used. The working group expects to consider further what purposes such summaries/narratives should serve, and may recommend different requirements for different types of life policies. The group is gathering and evaluating samples of actual summaries/narratives that are now in use, with a view to using "consumer testing" to evaluate how well such disclosures are fulfilling their purposes.

Adequate Compensation to General Account for Certain Separate Account Products

NAIC's Life Actuarial (A) Task Force (LATF) is reviewing issues relating to whether the pricing of certain separate account life insurance products adequately compensates the insurer's general account for the risks it assumes in connection with guarantees under the product. Among other things, LATF will consider whether opinions of qualified actuaries should be filed with state insurance regulators, attesting to the adequacy of such compensation. Alternatively, added disclosure relevant to this issue could be required in insurers' annual statement filings with regulators.

Policy Illustrations for Index Universal Life

The NAIC's recently-adopted Actuarial Guideline 49 regarding IUL illustrations became fully effective only this spring. Nevertheless, LATF has already approved significant revisions. Among other things, the revisions better adapt AG 49 to cases where an index account option has higher charges, in exchange for higher performance crediting rates (and/or higher performance cap rates), as compared to another index account option offered pursuant to the same policy. The changes are still subject to approval by the Life Insurance and Annuities (A) Committee and by the NAIC Executive Committee and Plenary, all of which could be accomplished as early as the NAIC's Summer National Meeting in August.

Going forward, expect the NAIC to further consider the contentious question of whether to modify the current language that makes the provisions of AG 49 inapplicable to in-force illustrations for IUL policies sold before the provision's effective date.

Insurance Data Security Model Law Update

On March 2, 2016, the NAIC's Cybersecurity (EX) Task Force exposed their draft of the Insurance Data Security Model Law. There has been robust discussion throughout industry and regulators regarding the content, including holding an interim meeting in May to focus on response and comments. The draft is undergoing revision, and is expected to be ready for further discussion at the NAIC's Summer 2016 National Meeting (August 26-29, San Diego).

NAIC ROUND-UP: SELECTED RECENT DEVELOPMENTS AT THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

BY TOM LAUERMAN & JOSEPHINE CICCHETTI

NAIC Cybersecurity Task Force Weighs Credit Freezes

BY JOSEPHINE CICCHETTI

On May 24-25, the NAIC Cybersecurity (EX) Task Force held an interim meeting to hear comments from various industry trade organizations and other interested parties on the proposed Insurance Data Security Model Law[1] exposed for comment on March 2. While the comments' themes largely echoed the written comments previously submitted by the interested parties, there was also a lengthy discussion on appropriate consumer protection measures to potentially implement following a data security breach. The March 2 draft of the Model Law provides for up to one year of free identity theft coverage, but the possibility that a credit freeze could be a superior measure was discussed at length.

What is a Credit Freeze?

A credit freeze[2] allows a consumer to restrict access to his or her credit report. As most creditors must access a consumer's credit report before approving a new account, a credit freeze prevents identity thieves from opening any new accounts in a consumer's name. However, this measure specifically protects consumers from the opening of new fraudulent accounts, and not against fraudulent activity in their existing accounts or other types of identity theft. In a data breach situation where personally identifiable information is stolen, a credit freeze is useful to protect against potential credit fraud. While credit freezes are often advised for identity theft victims, they can also be implemented to prevent fraudulent activity tied to a consumer's credit.

How it Works

To place a freeze on their credit report, consumers must contact each of the three major credit bureaus – Equifax, Experian, and TransUnion – and provide personal information along with their freeze request. Fees vary from state to state, and can range from $3 to $10 to initiate a freeze. Each credit reporting company will provide the consumer with a unique personal identification number to use should they need to lift the freeze. It can take from 15 minutes to three days[3] to initiate a freeze, depending on whether the request is made via postal mail, electronically, or by phone. Electronic and phone requests are the quickest ways to initiate a credit freeze.

Once a freeze is placed on a consumer's credit, access is completely restricted and no new accounts can be opened unless the freeze is temporarily lifted by the consumer. All existing creditors will still have access to the consumer's credit report throughout the freeze.

To lift a freeze, a consumer must contact each credit bureau again and request to either temporarily or permanently lift the freeze. A temporary lift costs from $2 to $12 depending on the state, and consumers must pay each time they need to make their credit available to a potential creditor or new employer. If the consumer can determine which credit bureau the potential creditor will use to check the consumer's credit, they can simply unfreeze their credit with that particular bureau to avoid extra costs. Some states waive temporary lift fees for identity theft victims or persons over age 65. To be eligible for the fee waiver, identity theft victims typically must provide a copy of a police report and in some cases an affidavit stating they believe that they are a victim of identity theft. The freeze can be lifted for a particular party or for a specified time period, and will be reinstated after that period. A permanent lift is typically free, though it depends on the state. The consumer can dictate when they want to permanently lift the freeze.

State Laws

All 50 states and the District of Columbia have enacted legislation to allow consumers to freeze their credit reports. Any consumer can request a freeze regardless of whether they are a data breach or identity theft victim. Although all states allow any consumer to initiate a freeze, some also mention the ability to freeze on behalf of minors or incapacitated persons. The National Conference of State Legislatures website[4] notes that 22 states allow "parents, legal guardians or other representatives of minors to place a security freeze on the minor's credit report: Arizona, Connecticut, Delaware, Florida, Georgia, Illinois, Indiana, Iowa, Louisiana, Maine, Maryland, Michigan, New York, North Carolina, Oregon, South Carolina, South Dakota, Tennessee, Texas, Utah, Virginia and Wisconsin."

Equifax created a fairly comprehensive list[5] of each state's fees for the freeze placement, date range lift, specific party lift, permanent removal, and replacement pin. The list also includes whether each state assesses different fees for identity theft victims or persons 65 years of age or older. In New Jersey, for example, identity theft victims are still required to pay a $5 fee for each temporary or permanent lift on a freeze. Whereas in New York, identity theft victims are not charged any fees. In South Carolina, both identity theft victims and non-victims can implement and suspend a credit freeze entirely for free. In Illinois, all fees are waived for active-duty military.

After a data breach, organizations must comply with data breach notification laws, which also vary by state. Forty-seven states and the District of Columbia have enacted legislation requiring private and government entities to notify individuals of a security breach involving their personal information. Security breach laws differ on who must comply with the law, the definition of "personal information", what constitutes a breach, requirements for notice, and exemptions. A 2015 amendment to Connecticut's breach notification law requires that an entity provide information on how to implement a credit freeze in its breach

notification to consumers (Conn. Gen. Stat. § 36a-701b(2)(B) (2015)).

Benefits of Credit Freezing as a Data Breach Remedy

In the event of a data breach, a credit freeze is considered a more effective remedy than credit monitoring in terms of prevention. Credit monitoring will only alert a consumer to fraud after the activity has occurred, while a credit freeze could prevent the fraud from happening altogether. The freeze can completely shield a consumer's credit from inquiries (*See Should you Freeze your Credit After a Data Breach?*[6]). While the credit freeze is in place, consumers can continue to use their existing accounts and will still be able to access free annual credit reports. Existing creditors, or collection agencies working on their behalf, will also have continued access throughout the freeze.

The credit restriction has the added bonus of forcing consumers to become more strategic and thoughtful when they want to open new credit. Generally, a credit freeze should not negatively impact a consumer's credit score. In fact, some believe it is more likely to help a consumer's credit score due to the reduced number of hard inquiries that can be made during the freeze (Hard inquiries are credit reviews made in the course of a lending decision that may have a small negative impact on a consumer's credit score.). Although credit freezes create more obstacles for consumers who want to open new accounts, they protect consumers' credit in a way that credit monitoring cannot. The benefit of this added security measure will likely outweigh the cost of implementation and maintaining a frozen account for data breach victims concerned about identity theft.

Drawbacks to Credit Freezing

Despite its benefits, freezing credit has some drawbacks. While a credit freeze can specifically prevent credit fraud, consumers are still vulnerable to other types of identity theft and abuse of their personal information. Some consumers may also be deterred by the cost and high-maintenance strategy of having to unfreeze and reinitiate the freeze every time they need access to their credit. For consumers who do not typically need access, such as senior citizens, a freeze may not cause any inconvenience.[7] However, for those who must access their credit history often, the freeze is much more burdensome.

Some have also expressed concern that a credit freeze could result in an increase in a consumer's insurance rates. Since some insurance companies use credit scores as a factor in determining insurance scores for underwriting and rating consumers, the inability to access the consumer's credit report may be erroneously interpreted as a negative factor by the insurer. (*See NAIC Credit-Based Insurance Scores*[8]). Steps to mitigate this potential risk would need to be devised if credit freezes are mandated by the Model Law.

Ultimately, a credit freeze doesn't completely eliminate the risk of becoming a fraud victim. Identity thieves still possess other tools to use against consumers. A freeze also will not stop misuse of a consumer's existing accounts and will prevent credit monitoring companies from tracking a consumer's credit to look for that misuse. So, while this tool effectively blocks fraudulent credit activity, it is important for consumers to continue to monitor their existing accounts and request credit reports as often as possible to keep track of those accounts.

Conclusion

To use the credit freeze as a Model Law requirement, regulators and the credit reporting agencies would need to work together to determine how this remedy could be administered in a breach situation. Since the individual affected must initiate a freeze of his or her credit, procedures would need to be devised to provide for individual decisions on whether a credit freeze is the correct or desired approach for a particular individual. The costs and administrative resources needed for such a measure may render this suggestion a good idea that falls short of a workable mandate.

The author would like to acknowledge the contributions of Laura Wall, summer associate from the University of Florida, in the preparation of the article.

[1] http://www.naic.org/documents/committees_ex_cybersecurity_tf_160524_draft_ins_data_sec_model_law.pdf

[2] https://www.consumer.ftc.gov/articles/0497-credit-freeze-faqs

[3] http://www.washpirg.org/resources/wap/tips-data-breach-victims

[4] http://www.ncsl.org/research/financial-services-and-commerce/consumer-report-security-freeze-state-statutes.aspx

[5] https://help.equifax.com/app/answers/detail/a_id/75/~/security-freeze-fees-and-requirements

[6] http://www.cbsnews.com/news/should-you-freeze-your-credit-after-a-data-breach/

[7] http://www.creditcards.com/credit-card-news/credit-report-freeze-1282.php

[8] http://www.naic.org/cipr_topics/topic_credit_based_insurance_score.htm

FINRA to Assess Member Firms' Cultures

BY TOM LAUERMAN

Speaking at the Brookings Institution this April, FINRA head Richard Ketchum emphasized the importance of a broker-dealer having a "culture" that favors the firm's customers when their interests conflict with those of the firm or its personnel.

Ketchum's remarks echoed FINRA views expressed in a variety of contexts over many months. For example, FINRA's January 5 "Regulatory and Examination Priorities Letter" for 2016 stated that it would "formalize" its assessment of firm culture, which it defined as:

"the set of explicit and implicit norms, practices, and expected behaviors that influence how firm executives, supervisors and employees make and implement decisions in the course of conducting a firm's business."

In February, FINRA did formally initiate an assessment via a targeted examination letter that it sent to several firms. The letter advised that FINRA planned to meet with a broad spectrum of the firm's executives to discuss the firm's cultural values and how the firm "communicates and reinforces those values directly, implicitly and through its reward system."

To provide background for these discussions, the letter asked the firm a series of specific questions. FINRA is "particularly interested in how [the] firm measures compliance with its cultural values, what metrics, if any, are used and how you monitor for implementation and consistent application of those values throughout your organization."

FINRA's objective is to "develop potential guidance for the industry and determine other steps that could be taken." Although the January 5 letter says FINRA "does not seek to dictate firm culture," it also states that an understanding of a firm's culture will "inform" FINRA's evaluation and the "regulatory resources" it devotes to the firm. And Ketchum told Brookings: "[W]e will continue to work with firms to ensure the industry fully embraces a culture that puts investors first."

NTIS MANDATES NEW REQUIREMENTS TO ACCESS THE DEATH MASTER FILE

BY BEN SEESSEL

In June, the National Technical Information Service (NTIS) promulgated a final rule setting out the requirements to become certified to access the Death Master File (DMF). The final rule amends the DMF certification program found in 15 CFR 1110, and was promulgated by NTIS, as delegee of the Secretary of Commerce, under Section 203 of the Bipartisan Budget Act of 2013. It supersedes and replaces an interim rule.

The DMF is a Social Security Administration database, which contains names, social security numbers, and dates of birth and death for U.S. citizens who have died since 1936. The final rule states that companies that wish to access the DMF must submit a written attestation from an accredited conformity assessment body (ACAB), as that term is defined in the rule, stating that the company has proper information security systems, facilities, and procedures in place to protect the security of the DMF. The final rule also authorizes the ACAB to conduct periodic audits of companies with access to the DMF. NTIS stated in supplemental information accompanying the announcement of the final rule, however, that companies subject to privacy security requirements laws such as the GLBA, FCRA, and HIPAA, should not be expected to incur the burden of a DMF-specific audit when they have had or will have an appropriate independent assessment or audit performed for other purposes.

The final rule enumerates possible penalties for unauthorized disclosures or use of the DMF. Penalties can include a $1,000 fee payable to the U.S. general fund for each unauthorized disclosure to a non-certified person. The rule takes effect November 28, 2016. Any person or corporation previously certified under the interim rule will need to become recertified in conformity with the final rule's requirements.

The author would like to acknowledge the contributions of Laura Wall, summer associate from the University of Florida, in the preparation of the article.

Supreme Court Declines to Review Constitutionality of SEC In-House Court

BY NATALIE NAPIERALA & GABRIELLA PAGLIERI

The SEC's increased use of its own "home court" for enforcement proceedings has triggered constitutional challenges to SEC administrative proceedings (APs). *See* "Defendants Challenge SEC's Increased Use of Administrative Forum," *Expect Focus*, Winter 2015; "SEC Administrative Law Judge Appointments Held Likely Unconstitutional," *Expect Focus*, Summer 2015. Most of these cases, brought in federal district courts, allege violations of the Appointment, Removal, Due Process and Equal Protection Clauses, the Seventh Amendment right to a jury trial, and the non-delegation doctrine.

While some of these challenges have been decided on jurisdictional grounds, the underlying question of whether APs are constitutional remains unanswered by the U.S. Supreme Court, which has now twice declined to consider constitutional issues raised. In both *Bebo v. SEC* and *Pierce v. SEC*, petitioners argued that, among other things, the SEC's administrative law judges violate Article II because they are "inferior officers" and are hired by SEC staff instead of appointment by the President or the Commission itself. Neither case, however, presented the issue of constitutionality squarely to the Court. For example, in *Bebo*, the question posed was whether district courts can hear challenges before the Commission issues a final decision. And the petitioner in *Pierce* argued that the respondent waived his constitutional challenge, which he failed to raise during the AP and which he brought for the first time after losing an appeal on separate grounds.

Recently, the Eleventh Circuit in *Hill v. SEC* and the Second Circuit in *Tilton v. SEC* joined the Seventh and D.C. Circuits holding that constitutional challenges cannot be brought in federal district court until the Commission issues a final ruling.

Constitutional challenges remain pending in the D.C., Second, Fourth and Eleventh Circuits. For example, the D.C. Court of Appeals recently heard oral argument in *In re Raymond,* where a review is sought of the Commission's holding that the appointment of its ALJs is constitutional. The D.C. Court of Appeals may be the first appellate court to squarely address that issue, and a holding of unconstitutionality could motivate the Supreme Court to at last grant certiorari to review the question.

Time to Disrupt Insurance Regulation?

BY ANN YOUNG BLACK

Innovators are not only disrupting the financial industry but also financial regulation as regulators weigh how to monitor financial technology (fintech) innovators and their new products and services. As they begin to address insurance industry innovation, or "insurtech," U.S. insurance regulators can benefit from the work of other countries' financial regulators.

Overseas financial regulators have been examining how to balance the needs for consumer protection and a sound financial system with a climate that fosters innovation in financial services. For example:

- In October 2014, the UK Financial Conduct Authority launched its Project Innovate to help innovative businesses understand the regulatory framework, and to review the UK's regulatory framework to remove barriers to entry and encourage and support innovation while continuing to protect consumers and the integrity of the UK financial system. It subsequently launched its Regulatory Sandbox as a safe space for innovators to test "innovative products, services, business models and delivery mechanisms in a live environment without incurring all the normal regulatory consequences."

- In April 2015, the Australian Securities and Investments Commission (ASIC) launched its Innovation Hub to help fintech startups develop innovative financial products or services for navigating the ASIC regulatory system. ASIC also proposes a regulatory sandbox for fintech start-ups to test their ideas with live customers.

- On June 1, France's Autorite de Controle Prudentiel et de Resolution created the FinTech Innovation Unit to analyze banking and insurance innovations and recommend changes to the regulatory framework and supervision practices.

In the United States, the Consumer Financial Protection Bureau (CFPB) and the Office of the Comptroller of the Currency (OCC) lead the way in considering regulation's impact on innovation. In August 2015, the OCC announced an initiative to develop a comprehensive framework to identify and understand financial services industry trends and innovations. In March, the OCC issued its white paper "Supporting Responsible Innovation in the Federal Banking System: An OCC Perspective," setting forth eight guiding principles for the OCC's approach to responsible innovation and seeking requests for comments. Key principles include:

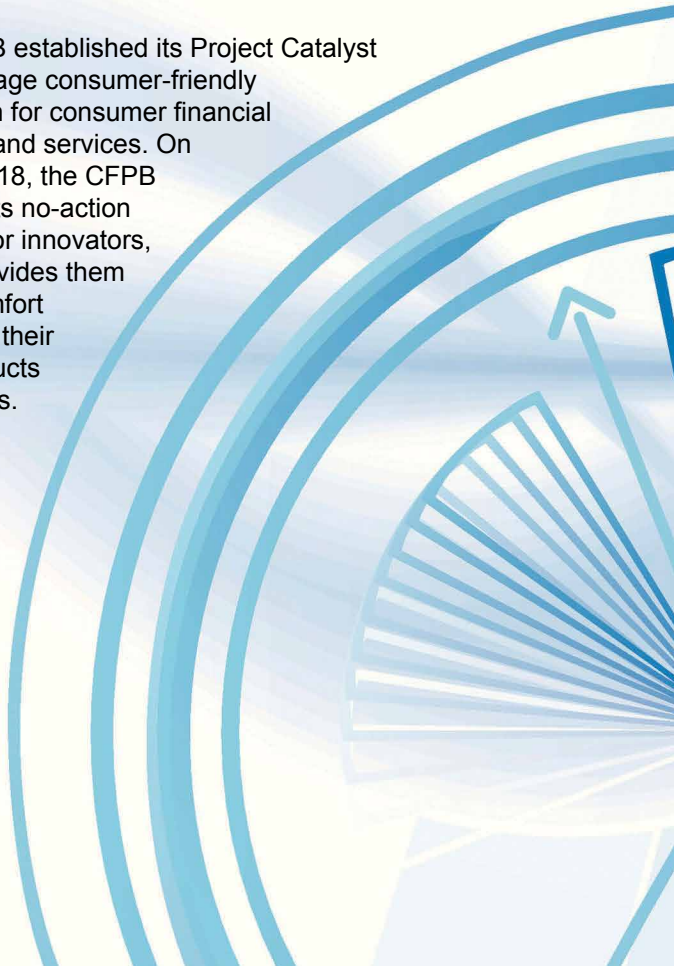
- Supporting responsible innovation – the OCC seeks an improved process to provide a clear path for banks and other stakeholders to seek the agency's views and guidance and is considering a centralized innovation office. A goal of this improved process would be to clarify expectations and promote better understanding of the regulatory regime.

- Encouraging responsible innovation that provides fair access and fair treatment – the OCC believes innovations should broaden access to financial services by delivering more affordable products and services to the unbanked and underbanked.

- Encouraging banks to integrate responsible innovation into their strategic planning – the OCC reminded banks that in considering innovative products and services, traditional strategic planning criteria apply.

- Promoting ongoing dialog through formal outreach – the OCC plans to hold a variety of workshops and meetings to discuss responsible innovation in the financial industry and innovation fairs to bring innovators together with OCC experts to discuss financial industry regulatory requirements and supervisory expectations. The first such dialogue took place on June 23, at the OCC's Forum on Supporting Responsible Innovation in the Federal Banking System. Developments, opportunities, and challenges related to financial innovation were discussed.

The CFPB established its Project Catalyst to encourage consumer-friendly innovation for consumer financial products and services. On February 18, the CFPB finalized its no-action process for innovators, which provides them some comfort regarding their new products or services.



While Iowa Commissioner Nick Gehart has encouraged innovators to gain an understanding of insurance law and the regulator's role, U.S. insurance regulators have yet to begin to comprehensively address innovation and consider whether potential regulatory changes are necessary to address insurtech. To date, insurance regulators have focused on innovations already used by insurers (e.g., price optimization and big data) and on other innovations impacting the insurance industry, such as the sharing economy.

Insurance regulators, however, must start to look ahead as insurtech begins to accelerate. In addressing innovation in insurance, considerations for insurance regulators include:

- Uniformity across jurisdictions. If some type of uniformity is not developed, innovators and the insurance industry will face regulatory uncertainty. This will either stymie innovation or result in an unlevel playing field as some innovators will simply operate outside the lines of insurance regulation. If regulations subsequently address and allow new innovations, the current industry players would be adversely affected by the first mover advantage gained by innovators operating outside the lines.

- Proactive engagement with innovators. To avoid playing catchup, other financial regulators are actively engaging innovators in a manner that allows them to openly discuss their ideas and seek meaningful regulatory input. This engagement also lets regulators work with innovators to ensure appropriate consumer protection safeguards are built into their new products and services and that innovators bear appropriate risk levels. The question remains, how will this engagement with insurance regulators take place—with individual jurisdictions or in a centralized manner?

- Resources. In reviewing new innovation, insurance regulators may need additional resources (e.g. personnel, technology, expertise, etc.). Acquiring these resources in a timely manner will be critical.

Insurance regulators and the industry must collaborate with innovators to harness the power of emerging insurtech. Re-examining insurance regulation is one step in that process.

Supreme Court's *Spokeo* Decision Leaves Questions Unresolved

BY AARON S. WEISS

On May 16, the Supreme Court issued its *Spokeo v. Robins* decision. *Spokeo* was a closely-watched case, as it had the potential to substantially limit federal court jurisdiction in cases where plaintiffs sued for violations of federal statutes and only sought statutory damages. But the Court's 6-2 decision turned out to be fairly narrow.

The plaintiff filed a class action against Spokeo alleging violation of the Fair Credit Reporting Act, 15 U.S.C. § 1681 (FCRA). Specifically, plaintiff alleged Spokeo published inaccurate information about him. In resolving a challenge to standing, the Ninth Circuit held that stating a violation of a statutory right is sufficient injury-in-fact to confer standing.

Justice Alito, writing for the majority, reversed this decision, holding that the Ninth Circuit's standing analysis was "incomplete" because it focused only on the particularized nature of the injury-in-fact requirement for constitutional standing, but did not address the concreteness requirement. For an injury to be particularized, it must affect the plaintiff in a personal and individual way. Justice Alito held the complaint satisfied this requirement. The injury also must be concrete, meaning it "must actually exist." Moreover, according to the Court, Congress can identify and elevate intangible harms to the level of concrete injury in certain circumstances.

When it enacted the FCRA, Congress sought to curb the dissemination of false information by adopting procedures designed to decrease that risk. On the other hand, the plaintiff could not satisfy the concreteness requirement by alleging a "bare procedural violation." Not all inaccuracies in information cause harm. Justice Ginsburg's dissent, in which she was joined by Justice Sotomayor, posited that the plaintiff had indeed alleged enough about concreteness to cross the threshold on this point.

As evidenced by the favorable reaction from both consumer and industry groups, it is unclear who will ultimately benefit most from the opinion.

A CONSTITUTIONAL CHALLENGE TO FLORIDA'S NEW UNCLAIMED PROPERTY ACT AMENDMENTS

BY STEVEN KASS

In April, Florida amended its Disposition of Unclaimed Property Act ("Act") to require life insurers to perform Death Master File (DMF) searches for all policies issued since 1992. The amended Act also provides that a DMF match creates a presumption of death, which starts the Act's unclaimed property reporting timetable based on date of death. By contrast, Florida law has long required insurance policy forms to state that death benefits are not due and payable until after the insurer receives due proof of death.

During the legislative process, the insurance industry argued the Act would unconstitutionally apply retroactively. Seeking to bulletproof the new law against this challenge, the Florida Legislature stated in the Act, "The amendments made by this act are remedial in nature and apply retroactively." Four life insurers, led by United Insurance Company of America, immediately sued Florida CFO Jeff Atwater and Florida's Department of Financial Services to invalidate the Act as violating the Florida Constitution's due process requirements and its prohibition against impairment of contracts. The insurers also asked the court to enjoin the Act's retroactive enforcement.

Three of these four insurers previously sued to invalidate a 2013 Kentucky law that also retroactively required DMF searches and used date of death as the unclaimed property reporting trigger. At trial, a Kentucky court found the law was "remedial" and thus could be applied retroactively, and that it did not impair vested contractual rights. A Kentucky appeals court reversed, finding the new law "substantive," not "remedial," because it shifted the burden to the insurer to obtain evidence of death following a DMF match, which also commenced the time for payment. Having reached that conclusion, the appellate court did not address the constitutional "impairment" issue. How Florida's courts resolve these issues remains to be seen.

New York Appellate Court Finds "Electronic Data" Exclusion Applies to Data Breach

BY JOHN PITBLADO

The computer network of a Five Guys Burger franchise, RVST Holdings, LLC (RVST), was hacked. Customers' credit card information was stolen and used to make numerous fraudulent charges. Trustco Bank brought an action against RVST, alleging it was negligent in securing Trustco cardholders' information, causing Trustco to sustain damages related to reimbursing its cardholders for the fraudulent charges.

RVST sought coverage for the Trustco claim from its insurer, Main Street America Assurance Company (Main Street) under a business owner's insurance policy. Main Street declined coverage.

RVST then brought an action against Main Street in a New York state trial court. Main Street moved for summary judgment, citing, among other things, the policy's exclusion for "damages arising out of the loss of … electronic data." The state court judge denied the motion, and Main Street appealed.

In *RVST Holdings, LLC v. Main Street America Assurance Co.,* New York's appellate division reversed, with orders to enter summary judgment in Main Street's favor. Notably, the appellate division's opinion makes evident that the claim was submitted for coverage under the policy's liability coverage for "sums that [the insured] becomes legally obligated to pay as damages because of … 'property damage'."

The court held there was no liability coverage for "property damage" (and thus no duty to defend) for two reasons: (1) the definition of "property damage" included the following explicit caveat: "for the purposes of this insurance, electronic data is not tangible property"; and (2) the policy's "electronic data" exclusion unambiguously applied to the subject data breach, which the court held plainly constituted "damages arising out of the loss of … electronic data." The court also rejected the insured's contention that because the first-party property coverage did not contain the same exclusion, coverage should somehow obtain. The court was dismissive, noting the first-party property coverage was inapplicable to a third-party claim.

This case may mark the beginning of the end of coverage battles for cyber-risks under traditional, non-cyber policies, which now typically include exclusionary language similar to that relied on by the New York Appellate Division. Thus, questions of whether a data breach might constitute a privacy invasion that constitutes a "personal or advertising injury" or if non-functioning hardware or software might constitute "property damage," will now largely become academic (perhaps until some theory of long-tail delayed trigger brings older pre-exclusion occurrence policies back into play). The decision also counsels policyholders to ensure they carefully review their coverage and fill any possible gaps for ever-evolving cyber risk.

A New Domain Name Option for the Insurance Industry

BY MORGAN L. SWING

Global insurance industry members have a new online tool—the ".insurance" domain name extension. This generic top level domain (gTLD), governed by insurance industry and security experts, is reserved solely for verified insurance providers and distributors. The exclusivity and additional security of .insurance can differentiate and increase insurance providers' online presence beyond what prior domain options offer. While the benefits carry greater expense, the new tool's ability to prevent potential future infringement or cybersquatting may make registration appealing.

.Insurance, a trusted and verified location exclusive to insurance domain name registrants and their customers, is more secure than most other gTLDs (such as .com). .Insurance has strict eligibility requirements, a comprehensive verification process, and enhanced security controls exceeding most gTLDs.

Only insurance community members, including licensed insurance companies, agents/agencies, or brokers/brokerages are eligible to register. Membership verification requires submitting proof (e.g., business license or certificate of formation) for registrars to review and approve. Verification is required at the initial registration (with minimal registration of one year) and at each renewal or every two years, whichever comes first. Furthermore, .insurance registrants must comply with strict security requirements.

The verification process and increased security standards are intended to create more trust in the insurance providers and their websites, although their efficacy remains unproven. Similarly, the industry-related domain name extension is supposed to improve a registrant's search engine rankings and enhance its online presence.

On the downside, the .insurance domain is more expensive than most gTLDs. The verification process adds expense. Although each registrar sets its own cost, a one-year registration is approximately $1,000 plus verification costs, and re-verification is required at least every two years. A new domain name requires additional marketing costs. Additionally, registrants must host .insurance domains on .insurance name servers and comply with enhanced security and operational requirements. These include strong encryption (TLS/SSL), domain name system security extensions (DNSSEC) to ensure users land on registrants' actual websites rather than malicious ones, email authentication, and full disclosure of registrants (no proxy registrations).

Insurance insiders must seriously consider preventing others from registering their trademark or trade name. Verification makes .insurance squatters less likely, although not impossible. Eligibility requirements would likely preclude most insurance outsiders. Additional requirements permit only registration of a domain name corresponding to a business' own trademark, trade name, or service mark and forbid deceptive domain names; however, the potential for domain name variations and acronyms means this is not foolproof. Thus, despite being a costly precaution, pre-emptive registration will likely be far less costly than later-arising infringement or cybersquatting issues.

General availability registration for .insurance domain names began June 15.

SEC Committee Recommends Investor-Specific Mutual Fund Cost Disclosures

BY ZACHARY LUDENS

In mid-April, the SEC's Investor Advisory Committee (IAC) issued a recommendation that the SEC "explore ways to improve mutual fund cost disclosures."

As a first step, the IAC urges the SEC to require that periodic account statements delivered to each mutual fund shareholder set forth the actual dollar amount of the direct and indirect costs borne by that shareholder over the period.

The SEC has previously declined to require such customer-specific disclosure, given the substantial costs it would impose on funds. Rather, the SEC has required that mutual funds disclose the costs investors bear as a percentage of net assets and as a dollar amount per $1,000 of investment. However, the IAC believes the current location and nature of such disclosures do not provide optimal investor understanding of the actual costs they bear and the impact of those costs on total accumulations over the life of their investment.

Longer term, the IAC recommends that the SEC consider, among other things, ways to contextualize the cost information for investors. For example, mutual funds could be required to make disclosures that compare the level of their costs to the average benchmark costs for other funds with similar characteristics.

The IAC was established under Dodd-Frank provisions that require the SEC to "promptly" issue a public statement assessing each IAC recommendation and disclosing the responsive action, if any, the Commission intends to take. Moreover, Dodd-Frank requires the SEC's "Investor Advocate" (who is also an ex officio member of the IAC) to annually report directly to Congress about what recommendations the IAC has made, and how the SEC has responded.

Accordingly, the IAC's recommendations are expected to spur substantive consideration at the SEC and, perhaps, in Congress.

PENSION INCOME STREAM PRODUCTS WORRY FINRA

BY JOSHUA WIRTH

Some SEC-registered broker-dealers connect individuals wishing to cash in on their future pension payments with potential investors in such income streams. In April, the Financial Industry Regulatory Association (FINRA) published Regulatory Notice 16-12, highlighting certain concerns over its member firms' involvement in such transactions.

Under a typical pension income stream product, the selling pensioner receives a lump-sum amount from the purchasing investor and, in return, is contractually bound to make future payments of pension income to the investor. The FINRA member is typically a pension purchasing company operating as an intermediary and facilitating the investment and subsequent payments. The Notice identifies unique and complex issues facing such FINRA members. These include the possibility of:

- Advertisements incorrectly leading investors to believe the product is a "safe" investment;
- Investors not fully understanding that, because federal law prohibits the assignment of pension assets, their only recourse for non-payment may be a breach of contract claim against the pensioner;
- Insufficient disclosure by pension purchasing companies to investors about commissions payable on the transaction and the illiquidity of the investment;
- Insufficient disclosure by pension purchasing companies to pensioners, including about the difference in value between the lump sum received versus the pension payments the pensioner is giving up; and
- Unavailability to the investor or pensioner of protections under securities or consumer lending laws, if pension purchasing companies incorrectly conclude that the product in question is not a security or a loan.

Member firms that neglect to consider such issues, especially in light of recent case law and administrative proceedings finding similar products to be securities, risk violating federal securities laws and FINRA rules. FINRA suggests firms either prohibit sales of pension income stream products or adopt specific policies and procedures, including training of associated persons, regarding these products.

NEWS AND NOTES

Carlton Fields was recognized by corporate counsel as one of the top law firms in the country for client relationships in the insurance industry. BTI conducted a national survey of insurance industry corporate counsel and chief legal officers, and lauded Carlton Fields for achieving the "gold standard" in client relationship skills. The gold standard designation means a firm is both a company's primary outside counsel and recommended freely. According to "*BTI Power Rankings*: The Law Firms With the Best Client Relationships," Carlton Fields is one of only 16 law firms in the country to achieve the gold standard in the insurance industry.

Corporate Counsel named Carlton Fields Washington, D.C. and Miami shareholder, **James F. Jorden,** a "Client Service All-Star" in BTI Consulting Group's 2016 survey. The survey identifies lawyers who demonstrate superior client focus and legal skills; deliver outstanding results and outsized value; have an unmatched business understanding; and apply innovative thought leadership to their clients' business and legal objectives. This year's report names 312 lawyers from 163 law firms. Attorneys named to this elite group are identified solely through unprompted client feedback.

In the Client Service Strategist category, **Carlton Fields** was ranked among the Top 10 as a "Best of the Best Client Service Strategist" in "*The BTI Brand Elite 2016*: Client Perceptions of the Best-Branded Law Firms." Overall, corporate counsel ranked the firm in the top 25 percent in the 2016 *BTI Brand Elite*.

For the second consecutive year, **Carlton Fields** was named on the "BTI Most Recommended Law Firm" list, which is based solely on in-depth interviews with leading legal decision makers at large and *Fortune* 1,000 companies with $1 billion or more in revenue.

The firm and the Insured Retirement Institute (IRI) hosted "Answering the 'Top Ten' Key Questions About the DOL Fiduciary Rule," a March 8 webinar that addressed the scope and status of the proposed DOL rule and related exemptions, and potential legal challenges to the rule. Shareholders **James Jorden, Stephen Kraus**, and **Michael Valerio** led the webinar.

Stephen Kraus was a panelist for the April 21 webinar "Is there a Future for Insurance Agents Under The DOL Rule." Hosted by *Insurancenewsnet*, the webinar covered changes to the DOL Rule.

The firm and IRI hosted "Recent Developments in Annuity and Life Insurance Litigation," a May 11 webinar led by shareholders **Julianna Thomas McCabe, Dawn Williams, Michael Valerio**, and **Waldemar Pflepsen**. The webinar focused on important annuity and life insurance product case rulings, new lawsuits, new theories, and class action developments that impact industry exposure.

Carlton Fields sponsored the IRI's Government, Legal, and Regulatory Conference, held June 6-8, in Washington, D.C. A panel featuring **Mike Valerio**, **Brian Perryman** and **Wally Pflepsen** discussed litigation exposure arising from the DOL's final fiduciary rule and recent lawsuits challenging the rule. The firm also co-sponsored a full-day workshop on the rule's implementation. **Mike Valerio** moderated a discussion for record-keepers and other service providers, **Ann Black** moderated a workshop for annuity manufacturers, and **Richard Choi** moderated a workshop for broker-dealers. Additionally, **Josephine Cicchetti** spoke and moderated a panel on the "Latest Developments in Cybersecurity Risk and Regulation," and **Jim Jorden** spoke on a panel on "Breaking Down the DOL Fiduciary Proposal."

Robert DiUbaldo was a panelist at American Conference Institute's 3rd National Forum on Insurance Allocation. The conference, held June 23-24 at the Carlton Hotel in New York, covered expert strategies and key insights regarding the most challenging allocation issues facing policyholders, insurers, and reinsurers. DiUbaldo presented on Intervention in Underlying Action for Special Jury Verdicts to Affect Allocation: Questions to Ask in the Underlying Case to Avoid Impairing Coverage Issues.

The ACLI Compliance & Legal Sections Annual Meeting was held July 11-13 in Boston. Shareholders **Stephen Kraus, Richard Choi,** and **James Jorden** presented on panels during the conference. Kraus was a panelist for "Product Design and Distribution in a Post-DOL Fiduciary World, which discussed the impact of the new DOL rule from the product side; and Jorden participated in a panel on the impact of the new DOL rule from the distribution side. Choi's panel, "DOL- IRA/Rollover and Variable Annuities/Index Annuities," focused on what the DOL's rule means for rollovers and non-fixed rate products.

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For more information, visit our website at www.carltonfields.com.

Atlanta
One Atlantic Center
1201 W. Peachtree Street | Suite 3000
Atlanta, Georgia 30309-3455
404.815.3400 | fax 404.815.3415

Hartford
One State Street | Suite 1800
Hartford, Connecticut 06103-3102
860.392.5000 | fax 860.392.5058

Los Angeles
2000 Avenue of the Stars
Suite 530, North Tower
Los Angeles, California 90067-4707
310.843.6300 | fax 310.843.6301

Miami
Miami Tower
100 S.E. Second Street | Suite 4200
Miami, Florida 33131-2113
305.530.0050 | fax 305.530.0055

New York
Chrysler Building
405 Lexington Avenue | 36th Floor
New York, New York 10174-0002
212.785.2577 | fax 212.785.5203

Orlando
450 S. Orange Avenue | Suite 500
Orlando, Florida 32801-3370
407.849.0300 | fax 407.648.9099

Tallahassee
215 S. Monroe Street | Suite 500
Tallahassee, Florida 32301-1866
850.224.1585 | fax 850.222.0398

Tampa
Corporate Center Three
at International Plaza
4221 W. Boy Scout Boulevard | Suite 1000
Tampa, Florida 33607-5780
813.223.7000 | fax 813.229.4133

Washington, DC
1025 Thomas Jefferson Street, NW
Suite 400 East
Washington, DC 20007-5208
202.965.8100 | fax 202.965.8104

West Palm Beach
CityPlace Tower
525 Okeechobee Boulevard | Suite 1200
West Palm Beach, Florida 33401-6350
561.659.7070 | fax 561.659.7368