

EXPECT FOCUS[®]

LEGAL ISSUES & DEVELOPMENTS FROM CARLTON FIELDS JORDEN BURT

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In This Issue:

- FINRA SHUFFLES CARDS
- CONSEQUENCES OF TARGET DATA BREACH
- ERISA DISGORGEMENT AWARD VACATED
- UNSETTLED QUESTIONS UNDER SCRA



More Bright Ideas!

New Year, New Name,
New Era

CARLTON FIELDS
JORDEN BURT

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Sixth Circuit Revisits Controversial ERISA Decision

BY IRMA SOLARES

The Sixth Circuit Court of Appeals voted to rehear an ERISA action that awarded an unprecedented remedy for the alleged denial of long term disability benefits. The order, granting en banc rehearing, vacates a controversial 2-1 panel decision that upheld a lower court decision in not only awarding the amount of the claimed disability benefits, but also ordering disgorgement of nearly \$4 million in profits allegedly resulting from the denial of benefits.

The now-vacated decision, *Rochow v. Life Insurance Company of North America*, arose from the denial of long-term disability benefits to Daniel Rochow, the former president of Arthur J. Gallagher & Co. Rochow's troubles started in 2001 when he began experiencing short term memory loss, chills, sweating, and stress at work. Unable to perform his duties as president, Rochow was demoted and ultimately forced to resign effective January 2, 2002. In February 2002, he experienced bouts of amnesia and was hospitalized. During his hospitalization, he was diagnosed with HSV-Encephalitis, a rare and debilitating brain infection.

As a Gallagher employee, Rochow was covered by a disability plan sponsored by his employer and administered by Life Insurance Company of North America (LINA). He filed for long-term disability benefits in late-December 2002. LINA denied his claim on the ground that his employment ended before his disability began and denied three appeals filed by Rochow on the same basis. Further, LINA found that Rochow failed to present any medical records demonstrating an inability to work prior to his resignation date. Rochow sued asserting that LINA wrongfully denied him benefits and breached its fiduciary duty under ERISA section 404 in doing so, claiming entitlement to relief under sections 502(a)(1)(B) and 502(a)(3).



The district court, on summary judgment, held that Rochow was entitled benefits that were improperly denied, a decision affirmed by the Sixth Circuit in *Rochow I*. After remand, Rochow sought an equitable accounting and disgorgement of LINA's "profits" earned on the \$900,000 in withheld benefits as "appropriate equitable relief" under section 502(a)(3). Years of litigation ensued, which included written discovery into LINA's profits, expert reports and depositions, and a full evidentiary hearing after which the court awarded approximately \$3.8 million as disgorgement of profits.

On LINA's second appeal to the Sixth Circuit (*Rochow II*), it argued that disgorgement was inappropriate because Rochow had an adequate remedy pursuant to section 502(a)(1)(B). The majority of the Sixth Circuit panel, however, agreed with the trial court and held that where a plan administrator acts "arbitrarily and capriciously," the remedy of disgorgement of profits could be "appropriate equitable relief" under section 502(a)(3), in addition to the award of benefits under section 502(a)(1)(B) and also held that *Varity Corp. v. Howe* did not preclude the award of equitable relief because "Section 502(a)(1)(B) cannot provide the equitable redress" Rochow sought. The dissent characterized the majority's decision as an "unprecedented and extraordinary step to expand the scope of ERISA coverage" and decried the \$3.8 million disgorgement as a "windfall" to the plaintiff.

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LINA filed a Petition for en banc review in the Sixth Circuit on December 20, 2013. On February 13, 2014, the American Council of Life Insurers, represented by Carlton Fields Jordan Burt, P.A., filed an amicus curiae brief in support of LINA, emphasizing the importance of the issue to the industry. Rehearing en banc was granted on February 19, 2014.



Insurer properly exercised discretion in calculating premium bonuses.

Summary Judgment Victory for Life Insurer in Annuity Class Action

BY JOHN PITBLADO

In *Tabares v. Equitrust Life Ins. Co.*, a California Superior Court granted summary judgment in favor of Equitrust in a class action on behalf of a previously certified class of California policyholders of certain market-indexed annuities.

The plaintiffs alleged that Equitrust breached the contracts in the manner in which it calculated both the minimum fixed interest rate, and the maximum caps on certain indexed-fund return rates; and in its application of the policies' premium bonus provisions. The plaintiffs also alleged wrongdoing related to Equitrust's sales practices. Based on the foregoing, they alleged breach of contract, fraud, violation of California's Unfair Competition Law, and declaratory relief claims.

The court previously certified a class of all California policyholders of four particular annuity products for the breach of contract claims, but denied certification based on any of the other theories. Notably, however, the breach of contract claim was treated as containing a claim for breach of the implied covenant of good faith and fair dealing.

In its recent decision granting summary judgment, the court rejected both the express and implied contract theories. First, it held that the express terms of the contract supported Equitrust's position that the premium bonuses were properly calculated and applied.

Second, it held that the discretion the contract afforded Equitrust to set renewal rates for the fixed rate provisions and the index caps, and the manner in which Equitrust calculated those rates, was not objectively unreasonable, and therefore did not support a claim for breach of the implied covenant of good faith and fair dealing. The court held that, because Equitrust exercised its discretion within the scope of the contract's express terms, "its use of that discretion to pursue its own advantage, even at the expense of class members is simply not actionable."

Favorable Secondary Life Market Report by Florida Regulator

BY DAWN WILLIAMS

The Florida Office of Insurance Regulation recently issued an opinion favorable to the insurance industry in its Secondary Life Insurance Market Report. Responding to a Florida Legislature directive, the OIR conducted a hearing, considered evidence, and sent a survey to nearly 400 life insurance companies. It ultimately found that redress to the courts – where insurers have recently been successful – provided adequate protection for purchasers of life insurance policies in the secondary market and no legislative action was needed.

The OIR rejected numerous suggestions from secondary market investors regarding possible changes to the law. In response to a proposal that subjective intent be made irrelevant to the question of insurable interest, the OIR surveyed Florida case law, which generally holds that insurance policies procured with the intention of being assigned or transferred are void ab initio. The OIR similarly did not recommend that insurable interest challenges be prohibited after a policy's contestable period, despite noting that Florida authority is split on that issue. The Office also declined to require a return of premiums if a policy is voided, noting that litigation in Florida has resulted in different outcomes depending on the facts of the case.

Two other rejected proposals included a requirement that a notice of validity of a policy from insurers be sent within 90 days of inquiry, and a mandate that the OIR monitor cost of insurance rate increases to prevent insurers from targeting investor-owners.

The OIR concluded that proposing the sought-after legislation would have the unintended consequence of encouraging stranger-oriented life insurance (STOLI) and fraud. Moreover, the current legal structure provided the correct avenue of relief, since courts have more flexibility to address the issues based on particular case facts. Given insurers' recent successes in Florida courts, and Florida's critical importance regarding STOLI issues, the opinion represents a significant industry victory.



Spring Sprouts a Renewed Review by the NAIC

BY ANN BLACK & KRISTIN SHEPARD

During and after the 2013 NAIC Fall National Meeting, various NAIC groups renewed their review of the regulatory framework for annuities. This review stems from the growing importance of annuities to address longevity risk. In its *Study of the State of the Life Insurance Industry: Implications of Industry Trends*, the NAIC's Center for Insurance Policy and Research acknowledged that insurers' longevity underwriting experience makes them a natural fit to fill the growing demand for longevity protection. It also recognized the desirability of including annuities within defined contribution plans, as well as the emergence of innovative products such as contingent deferred annuities (CDAs), to provide consumers with lifetime income protection. However, it noted the need to review and modify the current regulatory framework to address these products. Several NAIC groups are doing just that.

For CDAs, the CDA (A) Working Group (CDA WG) is coordinating and establishing the growing cycle for the NAIC groups addressing CDAs. These groups are considering the applicability of existing regulations to reserving, solvency, regulatory authority and consumer protections to CDAs. In addition, at the Fall Meeting, the CDA WG created a plan and timeline to develop a guide for states interested in clarifying the applicability of their annuity laws to CDAs. This included a plan to gather additional consumer-related information regarding CDAs at the Spring National Meeting, and

to draft the guidance by the Summer National Meeting.

At its Fall Meeting, the Life Actuarial (A) Task Force (LATF) received information about Actuarial Guideline 33 (AG 33), which sets forth the reserve required for fixed index annuities with guaranteed lifetime withdrawal benefits. The American Academy of Actuaries (AAA) presented its report on AG 33 and its recommended changes. LATF plans to review the AAA report and examples.

In December 2013, the budding Indexed-Linked Variable Annuity (A) Subgroup reviewed index-linked annuity products. These products provide a return based on the change in an index, including a portion of the negative change, and are funded by a separate account. It then issued a January 15, 2014 Discussion Points for Separate Account Index-Linked Products, outlining concerns that the current annuity regulatory framework does not address these products. It planted the following seeds for consideration: (i) whether these products should be subject to nonforfeiture standards; (ii) whether consumers understand interim values; (iii) whether these products would be subject to guaranty fund coverage; (iv) what reserves should be established; (v) what valuation applies to the separate account; (vi) what RBC applies; and (vii) whether there are other financial reporting issues. The Indexed-Linked Subgroup asked the insurance industry for its current practices on these issues,

and for its views on how the regulatory framework for annuities would need to be modified.

Insurers' longevity underwriting experience makes them a natural fit to fill the growing demand for longevity protection.

To facilitate the use of annuities within defined contribution plans, the ERISA Retirement Income (A) Working Group (ERISA WG) has been working on an ERISA Plan Fiduciary Best Practices Document. At the Fall National Meeting, the industry offered to provide the questions being asked by ERISA plan fiduciaries. The ERISA WG could consider these in revising the document to provide more meaningful guidance on the selection of immediate and deferred annuities for plans. In the meantime, the ERISA WG plans to continue its Department of Labor discussions on fiduciary duty safe harbor for selecting an annuity provider.



Seventh Circuit: Profit-Related Considerations OK in Setting COI Rates

BY SHAUNDA PATTERSON-STRACHAN

In December, insurers battling challenges to their exercises of discretion in setting non-guaranteed elements in universal life policies received a boost when the Seventh Circuit, via companion opinions, affirmed the dismissals of breach of contract actions by plaintiffs targeting the insurers' cost of insurance (COI) rates.

In both *Norem v. Lincoln Benefit Life Co.*, and *Thao v. Midland National Life Ins. Co.*, the court interpreted COI provisions that provided rates must be "based on" certain identified factors, and subject to maximum guarantees. The plaintiffs – both represented by the same law firms – had alleged that the insurers could only consider factors expressly identified in the policies, such as issue age, sex, policy year, and payment class. Plaintiffs argued that other pricing considerations such as profit margins were, by their absence from the contracts, forbidden. But after consulting dictionary definitions of the term "based on" to discern its plain and ordinary meaning, the Seventh Circuit concluded in *Thao* that "when the policy says that the monthly COI rate will be 'based on' specified factors, it does not mean that the rate will be based exclusively on those factors. ... Rather, it signifies that the named factors will have a significant, foundational role in determining the rate."

"It is not unreasonable in a universal life insurance policy to consider profit as a secondary factor in calculating the COI rate."

The Seventh Circuit also weighed in on competing COI rulings presented by the parties, ultimately recognizing that cases cited by the insurers, which "hold generally that absent a promise to use a specific formula when calculating a COI rate, an insurer is not bound to consider *only* those factors listed in a COI provision," were "more convincing." Indeed, in rejecting them, the *Norem* court said that the cases proffered by the plaintiffs "imply that a for-profit life insurance company should not be allowed to make a profit on its COI rates. This approach, however, seems disconnected from the reality of insurance. ... [I]t is not unreasonable in a universal life insurance policy to consider profit as a secondary factor in calculating the COI rate."

Federal Appellate Courts Address Stranger-Oriented Policies with Mixed Results

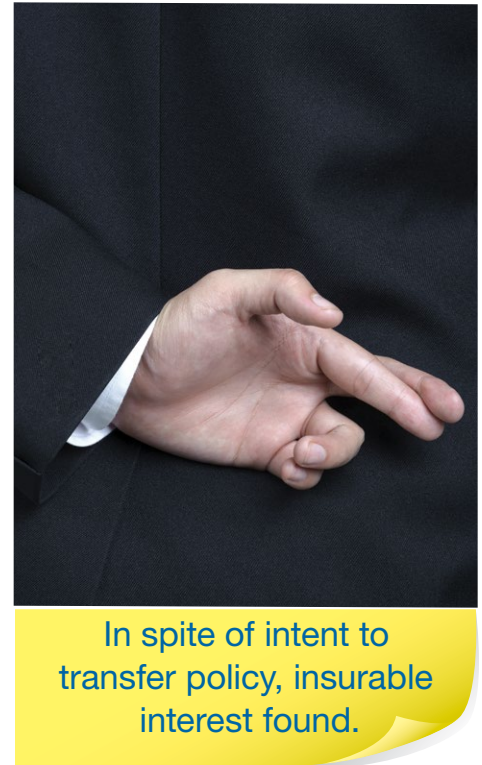
BY DAWN WILLIAMS

Federal appellate decisions concerning stranger-oriented annuity (STOA) and life insurance (STOLI) transactions are infrequent, making the First and Ninth Circuit's decisions this winter particularly interesting.

In one action, the Ninth Circuit affirmed a grant of summary judgment for the trust, finding that at the time the life insurance policy was issued, the son had an insurable interest in his mother's life, and thus, the policy was supported by an insurable interest despite the fact that the family had a pre-existing intent to transfer the policy. Further, the Court rejected the insurer's contention that the insured was not insurable up to \$8.75 million, holding that an individual has an unlimited insurable interest in her own life.

In *Western Reserve Life Assurance Co. of Ohio v. ADM Assoc. LLC*, the First Circuit certified the following questions to the Rhode Island Supreme Court related to a STOA scheme devised by Joseph Caramadre: (i) If the owner and beneficiary of an annuity with a death benefit is a stranger to the annuitant, is the annuity infirm for want of an insurable interest?, and (ii) Does a clause in an annuity that purports to make the annuity incontestable from the date of its issuance preclude the maintenance of an action based on the lack of an insurable interest?

In *Western Reserve*, the insurer sued for rescission and a declaratory judgment, and the trial court dismissed the complaint and amended complaint. The First Circuit was unsure how Rhode Island state courts would characterize a variable annuity for purposes of its insurable interest laws, and also how those courts would handle a potentially void policy that fell outside the contestability period.





Unclaimed Property Round Up

BY IRMA SOLARES & STEPHANIE FICHERA

The battle over unclaimed property continues to spawn increased litigation and regulatory activity.

Litigation Highlights

In December 2013, a West Virginia court dismissed 63 lawsuits brought by the Treasurer of the State of West Virginia (Treasurer) against life insurance companies doing business in West Virginia. The court rejected the Treasurer's attempt to accelerate when a life insurer's obligation to escheat policy proceeds arises. The lawsuits sought to create a duty on the insurance industry to search public records, such as the Social Security Administration's Death Master File (DMF), for deceased policyholders, even where the insurer received no claim or notice of the insured's death. The Treasurer alleged that insurers violated the Unclaimed Property Act (UPA), underreported abandoned property, and breached duties of good faith and fair dealing by failing to conduct annual searches of the DMF or similar databases for deceased policyholders.

The court held that the viability of the Treasurer's claims raised a threshold legal question: whether "the UPA creates a statutory duty obligating life insurance companies to periodically search the DMF or other similar database to determine if any of their policy holders have died." **The court ruled that no such duty exists under West Virginia law, rejecting the Treasurer's arguments that the UPA created general duties to act with "good faith" and pursuant to "reasonable commercial standards" which, in turn, required insurers to conduct annual DMF searches.** Finally, the court found that recent legislation imposing DMF or similar search requirements upon life insurers supported its finding that no such duty existed under the current UPA.

The Treasurer filed a notice of appeal to the Supreme Court of West Virginia on January 24, 2014.

Elsewhere, unclaimed property litigation is rising. The Controller of the State of California filed separate actions against four insurers and their subsidiaries accusing them of failing to use the DMF to determine if life insurance benefits were payable. The Controller seeks injunctive relief against several of the companies for their alleged failure to cooperate with audits conducted by Verus Financial LLC. Most of these actions are in the preliminary pleading stages, although the Superior Court granted a motion for preliminary injunction filed by the Controller, requiring an insurer to turn over in-force life insurance policyholder records related to the Verus unclaimed property audit. The insurer has appealed the ruling.

The industry is also carefully watching several actions pending in Florida.

Legislative and Regulatory Updates

Multiple carriers entered into settlements of multi-state unclaimed property examinations in late 2013 and early 2014.

In December 2013, the U.S. Government Accountability Office

(GAO) released its final report on the DMF, which raised numerous concerns and questioned the "accuracy and usefulness" of its data. The report further noted that the SSA does not verify all death reports before including them in the DMF and found that its "methods for processing death reports may result in inaccurate, incomplete, or untimely information for users of its death data," which "could lead to improper payments if benefit-paying agencies rely on this data."

Federal legislation imposing restrictions on DMF access was subsequently enacted in December 2013. The legislation prohibits disclosure of information contained in the DMF for three years following an individual's death, unless the person seeking the information is certified under a program to be established by the Secretary of Commerce. To be eligible for certification they must have a legitimate fraud prevention interest or business purpose in accessing the information, and established procedures to safeguard the information.

In early 2014, several states, including Indiana, Iowa, Mississippi, Oklahoma, Pennsylvania, and Rhode Island, introduced legislation requiring insurers to undertake routine DMF searches, a sure sign that states have not relented in their fight to accelerate escheatment of unclaimed property.

Case Closed: No More Neasham

BY KYLE WHITEHEAD

As reported in previous *Expect Focus* issues, *People v. Neasham* involved an insurance agent's criminal conviction for felony theft in connection with the sale of an annuity to an elderly woman whom prosecutors claimed had apparent dementia, and the subsequent reversal of that conviction by a California Court of Appeal. On January 15, 2014, the California Supreme Court denied a petition for review, thus sustaining the conviction's reversal.

Connecticut Court Declines to Open New Door to Coverage in Data Breach Cases

BY DIANE DUHAIME & BERT HELFAND

Massive data breaches, now commonplace, often prompt alarm. But the danger they represent—unauthorized use of confidential information—does not always follow straightforwardly. Nonetheless, a growing body of law requires companies affected by data breaches to take prophylactic measures. The cost and publicity of these measures can represent a significant loss, even if no identity theft ever occurs. When these indirect consequences of data breaches interact with the language of traditional insurance coverage provisions, problems can arise. In January 2014, in *Recall Total Information Management v. Federal Ins. Co.*, the Connecticut Appellate Court rejected several novel arguments about injuries of this type that could have broadly redefined the nature of “personal injury.”

Recall Total was responsible for storing and transporting data on various electronic media for IBM. In February 2007, approximately 130 electronic tapes containing confidential information of about 500,000 present and former IBM employees fell from the back of a van belonging to Recall Total’s subcontractor. The tapes were never recovered. IBM took immediate security precautions, such as notifying the affected employees and offering them identity theft protection. Recall Total later agreed to pay IBM more than \$6 million to cover the costs of those mitigation measures. None of the individuals whose data was lost reported any injury as a result of the incident.

Recall Total was an additional insured under its subcontractor’s commercial general liability policy. The policy required the insurers to provide Recall Total with a defense against certain kinds of “suit,” which was defined to include a “dispute resolution proceeding ... to which the insured ... submit[s] with our consent.” Recall Total argued that its nearly two years of negotiations, first with IBM and then its subcontractor, constituted either a “suit” or such a “proceeding.” The Court rejected the argument, making clear that the duty to defend is not triggered by “every



discussion, however informal.” The Court added that, in any event, defendants did not consent to the negotiations.

Plaintiffs also argued that Recall Total’s payment to IBM was covered under the personal injury provision of the policy. “Personal injury” was defined to include “injury caused by an offense of ... publication that ... violates a person’s right to privacy.” Plaintiffs contended that private data had been “published,” in that it was communicated to the unknown person or persons who removed the tapes from the place at which they were lost. The Court noted, however, that there was no evidence that anyone actually accessed the information contained on the tapes: no instance of unauthorized use had been reported, and, further, the tapes could not be read by a personal computer.

The court rejected plaintiffs’ position that an insurer’s duty to defend can be triggered by “every discussion, however informal.”

Plaintiffs also argued that IBM’s notice to its affected employees had been mandated by certain state privacy statutes, and that the triggering of those statutory obligations therefore constituted “presumptive invasions of privacy.” Plaintiffs argued, in other words, that the statute created a new type of “personal injury” that could be implied by law into the policies. The Court declined to do so, noting that the statutes “do not address ... identity theft or the increased risk thereof ... [but] merely require notification to an affected person so that he may protect himself from potential harm.” The trial court’s award of summary judgment to the insurers was affirmed.



Bad Caregivers Benefit from a Careless Defense

BY BERT HELFAND

Where an insured defendant is sued under multiple theories and coverage is available for only some of them, an Ohio appellate court has ruled that the insurer's duty to defend includes an obligation to recommend that the insured request special interrogatories to the jury to clarify coverage for damages.

World Harvest Church v. Grange Mutual Casualty Co. arose from a 2006 incident in which a World Harvest Church employee physically abused a child in the church's daycare program. The child's family sued the employee for battery and intentional infliction of emotional distress. The suit asserted claims against World Harvest directly for negligent supervision and intentional infliction of emotional distress, and also alleged that World Harvest was vicariously liable for the two torts the employee committed.

Grange expressly reserved its right to deny coverage, on grounds that included a molestation exclusion in World Harvest's liability and umbrella policies. But the insurer also retained counsel to defend World Harvest. The reservation-of-rights letter advised World Harvest that it might wish to consult independent counsel, and World Harvest ultimately retained its own lawyers to act jointly with the counsel Grange provided. The jury found the defendants liable on all counts and awarded compensatory and punitive damages. The compensatory damages totaled more than \$600,000.

The trial court held that Grange had the burden of proving coverage was



The duty to defend includes “the duty not to prejudice an insured’s rights by failing to request special interrogatories or a special verdict to clarify coverage or damages.”

unavailable for each cause of action asserted against its insured. Because the award was not allocated among the different theories, the court further held that World Harvest would be entitled to coverage for the full amount of the compensatory award, so long as coverage was available for at least one of the plaintiffs' claims. The Court of Appeals found that the insured generally has the burden of allocating a judgment. But it also held that this burden shifts to the insurer if the insurer fails to fulfill its duty to defend.

According to the appellate court, Grange violated that duty because the counsel it hired “was shown the proposed jury interrogatories and was given the opportunity to review and comment on them, and ... did not propose any interrogatories” relating to allocation. In other words, the court held that the duty to defend—a duty whose breach can expose insurers to a wide variety of serious consequences—includes “the duty not to prejudice an insured's rights by failing to request special interrogatories or a special verdict to clarify coverage or damages.”

Separately, the Court of Appeals found that the policies' molestation exclusion applied to all of the claims asserted directly against World Harvest. Grange was therefore liable only for the \$82,000 in compensatory damages that had been awarded against the employee. But this case establishes new law in Ohio, and it could have an expensive effect on future disputes.

Individualized Inquiries Defeat Class Certification in UM/UIM Case—Again

BY JOHN PITBLADO

Since around 2003, several class action lawsuits have been brought in Colorado against insurers alleging that it was misleading and deceptive to offer for purchase uninsured/underinsured motorist (UM/UIM) coverage on additional vehicles because such coverage was rendered illusory by a 2001 Colorado Supreme Court decision, *DeHerrera v. Sentry Ins. Co.*, in which the court held UM/UIM coverage follows the insured person, not the insured vehicle. The latest round appears to have gone to the insurers.

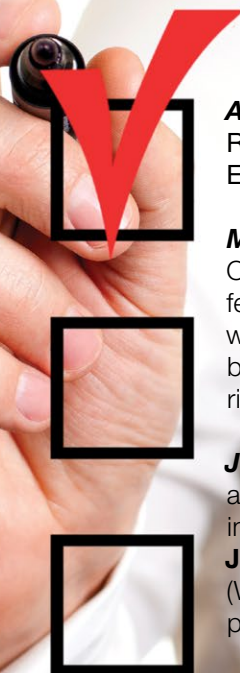
In *Maxwell v. United Services Automobile Association*, plaintiffs brought a putative class action on behalf of auto policyholders against USAA, alleging that it fraudulently concealed information necessary for policyholders to make an informed decision about purchasing uninsured/underinsured motorists coverage on additional vehicles. The trial court granted USAA summary judgment in 2007, but the Colorado Appellate Court reversed. Thereafter, the plaintiffs moved for certification of the class. The trial court denied the motion.

The plaintiffs again appealed to the Colorado Appellate Court, which this time affirmed, holding the trial court did not abuse its discretion in (1) admitting data compiled by State Farm about insureds' retention of UM/UIM coverage even after receiving notification of the *DeHerrera* decision, (2) holding



plaintiffs failed to demonstrate the necessary element of predominance under Col. R. Civ. Proc. 23, because it would require individualized inquiry to determine reliance, in light of the State Farm data that tended to show a statistical lack of reliance and, (3) finding the filed rate doctrine precluded a refund of any UM/UIM premiums that were paid based on rates filed with the Colorado Department of Insurance, thus barring recovery for plaintiffs' consumer fraud claims.

SAVE THE DATE



April 30-May 2 – Tallahassee Shareholder **Robert Pass** will present “Nuts and Bolts of Responding to E-Discovery” at the Defense Research Institute’s Life, Health, Disability and ERISA Seminar in Chicago, IL.

May 19-20 – Miami Associate **Pedro Pavón** will present “Privacy and Data Security Regulatory Overview” at the Privacy, Policy & Technology Summit in New York, NY. The conference will feature industry experts discussing top-of-mind privacy, tech, and data security issues and will leave the attendees with advice and knowledge that can be immediately applied to their businesses. Key topics include cybersecurity, mobile data security, strategies for privacy and risk mitigation in social media, and protecting data in the midst of corporate transitions.

June 29-July 1 – Carlton Fields Jordan Burt will once again co-sponsor the Litigation Track at the Insured Retirement Institute 2014 Government, Legal, and Regulatory Conference in Washington, D.C. **Wally Pflepsen** (Washington, D.C.) will co-moderate, and **Stephen Jordan** (Hartford), **Shaunda Patterson-Strachan** (Washington, D.C.), **W. Glenn Merten** (Washington, D.C.), **Markham Leventhal** (Miami), and **Rollie Goss** (Washington, D.C.) will present during the Litigation Track.



Title insurance policies typically contain a “survey exception” that excludes coverage for certain title defects that cannot be discovered without a physical survey. In some jurisdictions, insurers also offer to waive that exception for insureds who provide a survey (and pay a higher premium). But the effects on coverage can be asymmetrical. In January 2014, in *Lawyers Title Ins. Co. v. Doubletree Partners*, the U.S. Court of Appeals for the Fifth Circuit held that the absence of a survey exception made the insurer liable for the insured’s problems, even though an adequate survey would not reveal them.

In 2006, Doubletree purchased 36 acres in Texas, planning to erect 18 multistory residences for seniors. Lawyers Title issued a title insurance policy on the

property, and offered “more complete” coverage if Doubletree obtained a survey and paid additional premiums. As recently explained by the federal district court in New Hampshire in *Desjardins v. Fidelity Nat’l Title Ins. Co.*, “the precise location of boundary-defining monuments can only be determined by an examination of the property and an accurate survey,” and so “title insurance policies frequently except coverage for boundary disputes,” unless a survey is performed. Because Doubletree obtained a survey, Lawyers Title eliminated an exception for “discrepancies, conflicts, or shortages in area or boundary lines, or any encroachments or protrusions, or any overlapping improvements.”

Part of the appeal of Doubletree’s property was its proximity to a

large lake, but this also made it subject to a “flowage easement,” which permitted the U.S. government to flood areas with elevations below 537 feet. All parties knew of the easement, and the title policy specifically identified it as an exception to coverage. After consulting flood insurance rate maps, Doubletree’s surveyor concluded that the easement affected only a small portion of the property, and the sale was concluded. Unfortunately, the maps were wrong: flood water *could* potentially cover the sites of several proposed buildings. Delays resulting from this problem ultimately caused Doubletree to default on its loan obligations, and the property was sold in foreclosure.

The implications of this unusual case are unfortunate, at best.

Lawyers Title relied on three different provisions in contesting coverage; the Fifth Circuit held all three were ambiguous, and that coverage was required under the rule of *contra proferentem*. One term was the “survey coverage clause”—essentially, what remained of the survey exception, after the language eliminated by Lawyers Title had been removed. To support its finding that the clause could reasonably be read to mandate coverage for a fully-disclosed easement, based on the surveyor’s failure to determine correctly the elevation of the subject property, the court cited other cases that found coverage “when the defect [was] not revealed due to a survey error.”

In this case, Doubletree had filed a complaint against its surveyor with the Texas Board of Professional Land Surveying. The Board found that the surveyor had not violated any professional standards, and that the survey, however unfortunate, “appear[ed] to be adequate.” Apparently, the independent measurement of elevation is not a standard component of a professional survey in Texas.

Thus, the court found that removal of the survey exception obligated Lawyers Title to provide coverage for problems that an “adequate” survey would not disclose. The unusual facts of this case might limit its impact, but the implications are unfortunate, at best.

**Fifth Circuit
Adds a Third
Dimension to Title
Insurance Claims**

BY BERT HELFAND

LEFT EYE

RIGHT EYE



The SEC has been pursuing several initiatives that, taken together, would significantly increase the difficulties and uncertainties presented by the securities registration exemption found in Rule 506 of Regulation D.

Some of these complications (see “Advertising Under Rule 506: A Two Edged Sword,” *Expect Focus*, Vol. II, Fall 2013) would arise only in connection with offerings that take advantage of last year’s amendment by which the SEC permitted general solicitation (including advertising) in connection with Rule 506 offerings. Others would arise independent of any general solicitation, either from changes recently adopted by the SEC (see, e.g., “Bad Actors’ Barred from Rule 506 Private Placements,” *Expect Focus*, Vol. II, Fall 2013) or from changes merely proposed.

Proposed Form D Changes

Proposed changes pending would, for example, amend the Form D filing requirements in Rule 506 offerings to require issuers to:

- File a final amendment to the Form D within 30 days after termination of the offering.
- Provide extensive information about the number of (and amounts raised from) different categories of investors in the offering and how many investors have qualified as “accredited”: (a) by income, (b) by net worth, (c) by status as director, executive officer of the issuer (or of the issuer’s general partner), or (d) by “other” factors.
- Provide identifying information for each adviser that functions directly or indirectly as a promoter, if the issuer is a pooled investment fund; or if the issuer is not a pooled investment fund, information about the percentage (if any) of the offering’s proceeds that has been or will be used for each of six purposes the form prescribes.

Thus, issuers would be required to make sometimes difficult judgments about such matters as when an offering must be deemed “terminated,” who falls within the applicable definition of a “promoter,” and how certain investors or uses of proceeds should be categorized for purposes of the proposed new Form D requirements.

Penalty for Form D Deficiencies

The SEC is proposing that an issuer be disqualified from using Rule 506 for five years if it (or any of its predecessors or affiliates) has failed to comply with the Form D filing requirements. There would be various exceptions and limitations, including that any disqualification would end one year after any necessary corrections have been made in all Forms D (and amendments thereto) filed or required to be filed for the past five years.

Nevertheless, **it is worrisome that the proposed disqualification is worded broadly enough to be triggered by any Form D deficiency** – including not only failure to make a required filing but also, perhaps, any omission or mistake in completing the form or amendment thereto. Moreover, assuming that any Form D filing deficiency is inadvertent, the issuer could very possibly make subsequent offerings in reliance on Rule 506 without knowing that it had become disqualified from such reliance.

Clearly, any disqualification from reliance on Rule 506 could impose significant liabilities and other adverse business and legal consequences on the issuer; and private litigants (and even, occasionally, the SEC) may be tempted to “second guess” the sometimes difficult judgments that issuers may have to make in complying with some Form D requirements.

Increasing Chance of Form D Deficiencies

Even without the currently proposed changes, numerous uncertainties exist about the required content and timing of Form D filings and amendments. For example, difficult questions can arise about what transactions must be “integrated” (and thus deemed part of the same “offering” for Form D purposes). Regarding certain non-traditional types of securities, there may be significant doubt about even such basic matters as what entity should be reported on Form D as the “issuer.”

The currently proposed changes would, of course, further increase the likelihood of inadvertent errors in Forms D or amendments thereto, particularly regarding information that may change over time and must be monitored for the duration of an offering.



Increasing Regulatory Scrutiny

FINRA Rule 5123, adopted last year, requires member firms to submit to FINRA copies of private placement memoranda and other offering documents in connection with non-public offerings, with exceptions for insurance products and various other types of offerings. FINRA's published regulatory and examination priorities for 2014 state that it will use such filed materials to identify high risk offerings and will verify that firms' submissions pursuant to Rule 5123 are timely and accurate.

Moreover, such published priorities of both FINRA and the SEC's Office of Compliance Inspections and Examinations (OCIE) indicate that, in 2014, they will devote particular attention to marketing materials used in connection with Rule 506 offerings where general solicitation is used. FINRA, for example, wants to assure that the marketing materials "are based on principles of fair dealing and good faith, are fair and balanced, and provide a sound basis to evaluate the facts about [the] securities acquired."

FINRA and OCIE are also pressing for broker-dealer firms and investment advisers to perform adequate due diligence on private offerings in which they recommend or cause their customers to invest. See "More Due Diligence for Investments in Private Funds" on page 14.

In sum, the regulators are, in various ways, trying to provide more protections to investors in Rule 506 offerings, in response to developments such as the use of general solicitation, private fund losses (including those resulting from the Madoff fraud), and the complexity and opacity of many of the investments that are offered in reliance on the rule. Although this significantly increases the cost and legal uncertainties involved with many such offerings, the trend seems unlikely to soon reverse.

Rule 506: Too Cumbersome for Private Offerings?

BY TOM LAUERMAN





SEC: Justice Deferred is Justice Served

BY JASON BROST

The SEC recently announced its first deferred prosecution agreement (DPA) with an individual.

The individual had recently resigned as the administrator of the Hepplewhite Fund, LP, a Connecticut-based hedge fund, and the SEC agreed not to prosecute him after he voluntarily contacted the SEC to report wrongdoing by the fund’s manager. That report led to an emergency SEC enforcement action, which revealed both material

misrepresentations regarding the fund’s performance and the theft of \$1.5 million of investor money. As a result, the fund’s manager and his firm, which was the fund’s general partner, were required to pay \$6 million to compensate harmed investors.

An example of the SEC’s efforts to encourage the cooperation of reluctant insiders.

Under the terms of the DPA, the former administrator admitted to aiding and abetting the wrongdoing, disgorged \$50,000 he had received for his work with the fund, and accepted a five-year bar from work with hedge funds,

brokers, dealers, investment advisers, or registered investment companies.

Such a DPA is an example of the SEC’s recent efforts to encourage cooperation by insiders who are reluctant to offer information to the SEC for fear of exposing themselves to prosecution. The SEC reserves the right to bring and enforcement action against such cooperators in the future, however, if they violate the terms of the DPA. While the SEC has not previously used a DPA with an individual, it has previously done so with corporate entities, companies that have self-reported violations or otherwise cooperated fully with the SEC.

More Due Diligence for Investments in Private Funds

BY TOM LAUERMAN

The SEC’s Office of Compliance Inspections and Examinations (OCIE) issued a January 28, 2014 Risk Alert summarizing current practices and trends in how investment advisers conduct due diligence on private funds they recommend or cause their clients to invest in. Such funds include hedge funds, private equity, venture capital, and real estate funds, as well as “funds of” such funds.

Based on OCIE’s own observations and outside studies, the nine-page Risk Alert contains a wealth of information about due diligence practices and trends. Although OCIE generally does not specifically recommend procedures for advisers to follow, given their particular circumstances, many advisers will doubtless compare (and in some respects



conform) their procedures to those in the Risk Alert.

OCIE does, however, specifically identify the following as deficiencies:

- An adviser’s failure to annually evaluate the adequacy and effectiveness of its due diligence policies and procedures for private funds, notwithstanding that investing in or recommending such investments was a key part of the adviser’s business;

- Failure to assure that the adviser does not make disclosures about its due diligence practices and capabilities that are inconsistent with the facts or “with fiduciary principles,” or that are materially incomplete; and
- Investment in private funds by an adviser’s related persons on more favorable terms than are available to the adviser’s clients, without maintaining required records about why each such investment by a related person was permitted.

Broker-dealers, too, have extensive due diligence responsibilities when they are involved with private offerings. In 2010, FINRA articulated many of those responsibilities—which are often similar to those described in OCIE’s Risk Alert—in Regulatory Notice 10-22. Moreover, FINRA’s published regulatory and examination priorities for 2014 single out broker-dealers’ possible failures to perform these responsibilities as a prominent area of concern.



Variable Annuities Still in the Crosshairs

BY ANN FURMAN

For the first time in several years, variable annuities are not listed as a priority in FINRA's annual letter of regulatory and examination priorities. The omission from the January 2, 2014, letter may be partly due to the steady decline in the number of FINRA arbitration cases involving variable annuities—from 300 in 2009, to 174 in 2013—according to FINRA's website.

Nevertheless, FINRA head Richard Ketchum continues to pointedly refer to variable annuities as a FINRA focus. And, the SEC Office of Investor Education and Advocacy issued a February 6 investor bulletin addressing what an investor should do before purchasing a variable annuity.

Moreover, a significant proportion of qualified plan “rollovers” (principally from 401(k) plans to IRAs) involve variable annuities, and there are multiple indications that regulators are targeting those transactions. Such indications include:

- Prominent discussion of rollovers as a priority in FINRA's January 2, 2014, letter.
- FINRA's issuance during 2013 of two regulatory notices addressing concerns about financial advisers who encourage employees to roll over their qualified plan assets into IRAs without adequate disclosure or suitability analysis.
- A January 9, 2014 annual examination priorities letter issued by the SEC's Office of Compliance Inspections and Examinations (OCIE) that prominently announced plans to examine the sales practices of investment advisers and broker-dealers who target retirement-age workers to roll over their 401(k) plan assets into higher cost investments. OCIE's focus will include possible improper or misleading marketing, conflicts of interest, and suitability issues related to such transactions.
- A 2013 GAO report entitled “*401(k) Plans: Labor and IRS Could Improve the Rollover Process for Participants*” that also expressed concerns about advisers who do not adequately explain all available options or make suitability determinations.

With focus on rollovers coming from so many directions, variable annuity issuers may feel like they have a target on their back.



Final interagency rulemaking should clarify things.

Final Volcker Regulations Ease Mutual Fund Concerns

BY ED ZAHAREWICZ

Adopted in December 2013, the final interagency rulemaking to implement the Volcker Rule resolves a number of concerns raised by the mutual fund industry. Under the Volcker Rule, banking entities are generally prohibited from engaging in proprietary trading or investing in or sponsoring certain types of investment funds. Such “covered funds,” as the regulations call them, generally include any issuer that would be an investment company but for Section 3(c)(1) or 3(c)(7) of the Investment Company Act, as well as certain commodity pools.

By expressly excluding registered investment companies from the definition of a covered fund, the final regulations clarify that a registered investment company will not be treated as a covered fund even if the company is also considered a commodity pool. This benefits certain registered investment companies that use futures, swaps, or other commodity interests in their investment programs. The final regulations also address the problem that could arise for an issuer that is reasonably expected to become a registered investment company, but during its “seeding” period relies on Section 3(c)(1) or 3(c)(7). Specifically, the regulations also exclude such seeding vehicles from the definition of a covered fund, subject to certain conditions designed to prevent evasion of the general prohibitions on covered fund activities.

In addition, the final regulations make clear that **the Volcker Rule generally will not affect the ability of registered investment companies to invest in a covered fund, unless the registered investment company is itself a banking entity by virtue of being an affiliate of an insured depository institution.** In this regard, the adopting release discusses in some detail the considerable extent to which a banking entity may invest in or maintain certain relationships (for instance, as an adviser or organizer, sponsor, and manager) with a registered investment company without the Volcker Rule prohibiting the company's investment in any covered fund.



SEC: Investment company names should not overemphasize investment safety.

Some Fund Names Guarantee SEC Scrutiny

BY SCOTT SHINE

The SEC staff is trying to limit the use of investment company fund names that include terms such as “guaranteed” or “protected” that suggest protection from market, credit, or other risk. A recent Guidance Update issued by the Division of Investment Management encourages investment companies to consider eliminating or qualifying such terms.

The Guidance Update emphasizes that, even if the body of a prospectus and other disclosure documents qualify fund names by fully disclosing any limitations on the scope of the protection provided, investors often focus on a name to determine the level of risk. Accordingly, **the SEC staff has already requested that some funds (including long-established ones) change their names.** Practically speaking, any such change generally will involve removing the offending word (or any of its derivatives), as it is usually awkward to add satisfactory qualifying language to the name itself.

Still unresolved is the impact on names of variable annuity or variable life insurance products, or of specific benefits offered under them. These products and benefits, consistent with their insurance element, not infrequently have names that include terms such as “guaranteed” and “protection.”

At a recent industry conference, Division Director Norm Champ noted that, while insurance is frequently associated with protection, when it is also an investment product, the protection is often limited in significant ways, making it important that the product name not overstate the safety provided. On the other hand, at the same conference, an Assistant Director of the Division suggested that SEC staff may not consider it necessary to scrutinize the names of some rider benefits under these products as closely as the names of the underlying funds that support them.

FINRA: “Fiduciary” Standard Architect?

BY KYLE WHITEHEAD

FINRA is encouraging broker-dealers (BDs) to act in their customers’ best interests, although the “suitability” standard applicable to BDs does not expressly require it.

For example, in 2012, FINRA implemented an expanded suitability rule and released Regulatory Notice 12-25, elaborating on its position that BDs should be “acting in [customers’] best interests.” Similarly, FINRA’s Report on Conflicts of Interest last October urged BDs to implement strong conflict management frameworks, including a code of conduct based on the “best interests” standard.

These and other efforts to emphasize and define BDs’ conduct necessarily promote fiduciary-like duties of care and loyalty.

FINRA appeared to reinforce this notion when, last December, it announced the creation of an 11-member Investor Issues Committee (IIC) comprised of persons not currently associated with FINRA. Indeed, the IIC, which will advise FINRA on rulemaking and policy initiatives that impact investors, includes former SEC Chairman Elisse Walter. Ms. Walter has historically advocated a “harmonization” of the duties of BDs and investment advisers (IAs) such that BDs would have a more explicit fiduciary duty to their customers. The IIC also includes two members of the SEC’s Investor Advisory Committee, which, too, promotes investor interests and has advocated a fiduciary standard for BDs that would explicitly require them to act in their customers’ best interests.

It is unclear how closely the fiduciary-like standard that FINRA seems to be crafting for BDs will resemble the fiduciary standard already applicable to IAs. In any event, FINRA’s efforts may have some influence on the SEC’s ongoing deliberations about harmonizing such standards. FINRA may also be bolstering its credentials to advance its continuing ambition to be a self-regulatory organization for IAs.



FINRA Shuffles Comments on its “CARDS” Proposal

BY GARY COHEN



CARDS brings some uncertainty.

FINRA is reviewing a slew of comments on a controversial proposal to develop a comprehensive automated risk data system, nicknamed “CARDS.” FINRA published the proposal on December 23, 2013, in Regulatory Notice 13-42, and extended the comment deadline to March 21.

Under the CARDS program as originally proposed, FINRA would

systematically collect broker-dealer customer “account information, as well as account activity and security identification information that a firm maintains as part of its books and records.” At least initially, this “would generally represent the same types of information FINRA currently collects on a firm-by-firm basis during the examination process.” However, FINRA subsequently announced that it would not require information that would identify the individual account owner, particularly the account name, address and tax identification number.

The Regulatory Notice says the information would be used to “run analytics that identify potential red flags of sales practice misconduct ... as well as help FINRA identify potential business conduct problems with member firms, branches and registered representatives.” It defines “sales practice misconduct” to include “churning, excessive commissions, pump and dump schemes, markups, and mutual fund switching.”

Rather than formally proposing a rule, the Regulatory Notice sets out

a “concept proposal.” The intent is “to obtain the views of firms and others at the initial stage of determining how FINRA should obtain broader information to advance its supervision of firms and their associated persons.”

Commenters have raised a wide range of problems and questions with the CARDS proposal, such as:

- the uncertainty of the proposal’s objective and its lack of specific cost-benefit analysis,
- the difficulty and cost of providing data in the format that CARDS would require, on a standardized basis across the industry,
- the question of responsibility for data quality, particularly where introducing brokers would submit information to FINRA through clearing brokers,
- the obstacles to using third parties to perform functions, and
- security risk and customer privacy concerns.

NEWS & NOTES

Carlton Fields Jorden Burt is pleased to announce the successful completion of its merger, effective January 1, 2014, between Carlton Fields, P.A. and Jorden Burt LLP.

Gary L. Sasso, the firm’s President and CEO, has been selected for induction into the Tampa Bay Business Hall of Fame. To be considered, nominees must have lived or worked in the Tampa Bay region; made significant contributions to their industries; displayed sustained performance in their industry; be a business owner or top-level executive; participated actively in the Tampa Bay community; and reflect diverse genders and cultures. Mr. Sasso embodies all of these characteristics and was inducted March 6, 2014.

Washington, D.C., and Miami Shareholder **Frank G. Burt** was nominated by corporate counsel as a “Client Service All-Star” in BTI Consulting Group’s 2014 survey. The survey identifies lawyers who demonstrate exceptional legal skills and client focus; deliver outstanding results and superior value; and understand, and share a commitment to achieving, their clients’ business and legal objectives.



Expect Focus on Antitrust Issues in the Health Care Industry

BY JENNIFER CHRISTIANSON

There have been a number of high profile antitrust cases brought against health care providers, and the increasing interest of both the Federal Trade Commission (FTC) and plaintiffs should be considered in any proposed transaction or changes in business operations.

Federal regulatory enforcement efforts have increased. For example, the FTC challenged St. Luke's Health System's acquisition of Saltzer Medical Group in Idaho. A federal district court recently held that the acquisition violated the Clayton Act and the Idaho Competition Act, and ordered St. Luke's to divest itself of certain assets.

The FTC recently announced that it is hosting a public workshop on March 20-21, 2014, in Washington, D.C., to examine competition issues in the



The FTC will likely keep the heat on the health care industry in 2014.

United States health care industry. The workshop will address five key topics including: 1) professional regulation of health care providers; 2) innovations in health care delivery; 3) advancements in health care technology; 4) measuring and assessing quality of health care; and 5) price transparency of health care services.

The Commission will accept written comments on the workshop discussions through April 30, 2014; thus, it will likely continue to focus on the health care industry in 2014.

We expect plaintiffs to show an increasing interest in pursuing antitrust claims as well as state law claims based on allegations of economic credentialing and unfair trade practices. Recent examples include the claims pursued by Steward Health Care System LLC against Blue Cross & Blue Shield of Rhode Island based on allegations that the insurer interfered with its potential acquisition of a hospital. Notably, the federal district court recently denied Blue Cross & Blue Shield's motion to dismiss and allowed the case to proceed.



NEWS & NOTES 2

Carlton Fields Jordan Burt welcomes the following new attorneys to the firm: Shareholder **Marc L. Druckman** (Business Transactions, Miami), Shareholder **C. Cory Mauro** (National Trial Practice Business Litigation Section, West Palm Beach), Of Counsel **William P. Sklar** (Real Estate and Commercial Finance, West Palm Beach), Senior Counsel **Maria Mejia-Opaciuch** (Business Transactions (Immigration), Miami), and Associate **Heather M. Jonczak** (Construction, Miami).

Tampa Shareholder **Penelope A. Dixon** was chosen by the Leadership Council on Legal Diversity (LCLD) to be a member of its 2014 class of Fellows. The LCLD created its Fellows program to identify, train, and advance diverse leaders in corporate legal departments and law firms.

Carlton Fields Jordan Burt is pleased to announce the election of 12 new shareholders at the firm's 2014 All-Attorney Meeting which was held in Miami, Florida, on February 20, 2013. Eleven associates and one of counsel, in various offices and practices throughout the firm, were elevated. Congratulations to the following newly elected shareholders: **Christopher O. Aird** (National Trial Practice, Miami), **Andres F. Chagui** (Financial Services and Insurance Litigation, Miami), **Tenikka L. Jones** (National Trial Practice, Miami), **Michael E. Strauch** (National Trial Practice, Miami), **Radha V. Bachman** (Healthcare, Tampa), **Erin E. Banks** (Construction, Tampa), **Patricia S. Calhoun** (Healthcare, Tampa), **Jin Liu** (Real Estate and Commercial Finance, Tampa), **Brian Perryman** (Financial Services and Insurance Litigation, Washington, D.C.), **Dawn Williams** (Financial Services and Insurance Litigation, Washington, D.C.), **C. Todd Willis** (Financial Services and Insurance Litigation, Washington, D.C.); and **M. Derek Harris** (National Trial Practice, West Palm Beach).



Courts Continue to Wrestle with TCPA Consent

BY AARON WEISS & APRIL WALKER

The Telephone Consumer Protection Act (TCPA) prohibits non-emergency calls to cell phones using automatic telephone dialing systems or prerecorded voice messages absent the called party's prior express consent. Text messages are treated as calls under the statute.

In *Gager v. Dell Financial Services, LLC*, the Third Circuit Court of Appeals reversed a lower court decision to hold that a consumer can revoke prior express consent, for purposes of the TCPA, to be called at a number previously provided in writing to a creditor, and that there is no temporal limitation on the customer's right to revoke consent. Since *Gager*, which was decided in August of last year, the issues of consent, and whether it may be revoked, continue to arise in TCPA cases.

Relying on *Gager*, the federal district court in the Southern District of Florida ruled revocation of consent was sufficiently alleged for purposes of bringing suit for violating the TCPA. The consumer initially signed up for text message alerts but later took steps to stop them by following the company's instructions for unsubscribing to text messages.

In another text message alert case, *Baird v. Sabre, Inc.*, a California federal district court ruled that a consumer gave consent under the TCPA when she entered her cell phone number while booking an online airline ticket. In reaching this decision, the Baird court concluded that this situation was covered by the FCC's original rules implementing the TCPA (often referred to in TCPA cases as the 1992 FCC Final Order). Accordingly, based on the 1992 FCC Final Order, **the court found the consumer "knowingly release[d]" her cell phone number to the airlines when she entered it while booking her online reservation.** The court rejected the argument that the number was not voluntarily released simply because the airline required a contact telephone number to make the reservation.

Unsettled Questions Remain Under the SCRA

BY MICHAEL WINSTON & JOSHUA MOORE

The Servicemembers Civil Relief Act (SCRA) protects active duty members of the military in civil actions, including foreclosures and collections. Section 533 of the Act applies to persons entering the military *after* incurring the obligation, affording a stay of proceedings and prohibiting foreclosure during service. Separately, section 521 protects service members from default judgments in their absence. Before a default can be entered, plaintiff must file an affidavit indicating whether the defendant is on active duty. If not, the case proceeds. If so, the court will appoint a guardian ad litem and may enter a stay.



The punitive damages fight is just beginning.

On October 13, 2010, the SCRA was amended to add a private right of action for any violation. That amendment, codified at section 597a, expressly permits an action for equitable and declaratory relief, as well as recovery of monetary damages, including attorney's fees. In December 2013, the Ninth Circuit Court of Appeals heard *Brewster v. Nationstar Mortgage*, which involved an alleged section 533 violation – Nationstar attempted to collect foreclosure fees incurred in an action that had been dismissed. Following briefing on that issue, the court requested supplemental briefing on two questions: (1) whether the section 597 cause of action applied retroactively, and (2) whether punitive damages were recoverable.

Brewster relied on 597a to assert a private right of action; Nationstar asserted the amendment did not apply retroactively. While there is support for both positions, **courts are reluctant to find retroactive application of a statute without express legislative intent, and California's Central District has already found the private right of action was not retroactive for purposes of section 521's affidavit requirement.**

Brewster also argued that punitive damages were available for willful violations and that the term "monetary damages" used in the statute was sufficiently expansive to encompass them. Nationstar argued there was no legislative history to support recovery of punitive damages, and that such damages were not listed among categories of recoverable damages in the statute.

The Ninth Circuit declined to address retroactivity, finding Nationstar's conduct occurred after the amendment was adopted. However, the punitive damages fight is just beginning. The panel held the district court should make that determination on a more developed record. Because it remains unclear whether courts will give "monetary damages" a broad reading, the best bet is to ensure no violations occur – even technical violations of the SCRA – lest the lender, consumer creditor, servicer, or collector end up subject to punitive damages and public scrutiny for the perceived violation.



CFPB Continues Assault on Add-On Financial Products

BY ELIZABETH BOHN

The Consumer Financial Protection Bureau (CFPB), the Federal Deposit Insurance Corporation (FDIC), and the Options Clearing Corporation (OCC) have again required multimillion dollar refunds and penalties related to marketing add-on credit card products. In December, the Bureau and banking regulators ordered American Express to pay \$59.5 million to more than 300,000 consumers for unfair and deceptive marketing of credit card add-on products and unfair billing practices found to violate the Consumer Financial Protection Act, and for failing to provide free credit report options in violation of Reg V of the Fair Credit Reporting Act. The bank was also ordered to pay \$15.6 million in civil penalties to the CFPB, FDIC, and OCC.



In the latest order – the sixth entered by the CFPB and banking regulators regarding the marketing of credit card add-on products – the Bureau found that consumers were misled about the benefits, fees, and terms and conditions of the payment protection products marketed by telemarketers and other third-party vendors. It also required American Express to hire an independent third party to review credit card add-on products for compliance with consumer protection laws, and maintain better oversight over third-party vendors.

In 2012, the Bureau issued guidance advising that it considered third-party service providers to banks and nonbank consumer financial service providers “supervised entities” subject to its supervision, and that it would hold them responsible for violations of Federal Consumer financial law by their third-party service providers. The very first CFPB Consent Order entered jointly with the OCC against Capital One Bank that year – also involving add-on products marketed by third-party vendors – required the Bank to refund \$140 million to the consumers and assessed a \$25 million civil penalty. The six existing orders represent more than \$600 million in refunds to consumers and assessed civil penalties of close to \$100 million related to the marketing of credit card payment protection, identity theft, and other add-on products.

CFPB Report Highlights Focus on Mortgage Servicing

BY ELIZABETH BOHN

Under Dodd-Frank, the CFPB supervises depository institutions and credit unions with total assets of more than \$10 billion, as well as certain nonbanks, regardless of size, including mortgage companies, originators, brokers, and servicers. The CFPB has prioritized mortgage servicing problems, viewed as having contributed to the financial crisis, through new rulemaking and supervision. Recently, the Bureau issued a report listing mortgage servicing issues it found in 2013.

In January 2014, new CFPB mortgage servicing rules took effect. Amendments to the Real Estate Settlement Procedures Act (RESPA) require servicers to provide loss mitigation options and assistance to delinquent customers, and to refrain from foreclosure during the loss mitigation evaluation process. The RESPA amendments also added requirements for responding to consumers, resolving errors, record retention, and force placed insurance. TILA amendments require mortgage payments to be credited on the date of receipt, provision of accurate payoff balances within seven days of request, and 210 days’ advance notice prior to interest rate adjustments. Additionally, they prescribe content for rate adjustment notices; and content, delivery, and frequency of periodic billing statements.

Although mortgage servicing issues identified in the report occurred before the new mortgage rules took effect, the CFPB found they violated Dodd-Frank’s Consumer Protection Act’s ban on unfair, abusive or deceptive acts and practices. Examples cited include failure to honor loan modifications after servicing transfers, requiring borrowers to waive existing claims in connection with loan modification agreements with broad waiver clauses unrelated to individual circumstances, and failing to provide correct information to credit reporting agencies by misreporting short sales as foreclosures, negatively impacting the consumers’ credit.

CFPB examiners have imposed remedial measures and opened investigations for potential enforcement actions. In December 2013, the CFPB found Ocwen Loan Servicing, the nation’s largest non-bank mortgage servicer, engaged in what it found to be “systemic misconduct” in mortgage servicing and ordered Ocwen to provide \$2 billion in principal reduction to underwater borrowers and refund \$125 million to borrowers already foreclosed upon.



The CFPB and the Department of Justice (DOJ) are joining forces to pursue damages and penalties against consumer lenders for violation of the Equal Credit Opportunity Act (ECOA) in pricing consumer loans.

In a December 20 Consent Order representing the largest federal loan discrimination settlement in history, the DOJ and CFPB ordered Ally Bank to refund \$80 million to consumers allegedly damaged by discriminatory auto loan pricing, and to pay an additional \$18 million in penalties. On December 23, the DOJ and CFPB jointly filed a complaint and proposed Consent Order against National City Bank in a Pennsylvania District Court requiring PNC Bank, as successor to National City Bank, to establish a \$35 million settlement fund for African-American borrowers allegedly affected by discriminatory mortgage loan pricing.

ECOA prohibits discrimination by creditors in credit transactions based on race, sex, national origin, age, and other factors. It defines a “creditor” as including “assignees of original creditors who participate in the decision to extend, renew, or continue credit,” and “all persons participating in the credit decision.” **The statute does not require a showing of intent to**

discriminate, but rather, may be established if a creditor’s policies result in disparate impact—often demonstrated solely by statistical analysis—with respect to protected classes of individuals.

Joint investigations by the two agencies, which share enforcement authority for ECOA violations, into Ally Bank and National City’s lending practices and use of statistical analyses resulted in their findings of illegal loan pricing disparities based on race and national origin.

Ally Bank, as an indirect auto lender (it purchases loans originated by auto dealers), is considered by the Bureau to be a “creditor” under the ECOA because it participates in the evaluation of credit applicants and sets dealer buy rates for the contracts. When lenders permit dealers to mark up contract interest rates and compensate the dealer for the marked up rate, the CFPB considers that participation in a credit decision under the ECOA. The Ally Bank Order was based on a finding that this practice resulted in

higher interest rates charged to African-American, Hispanic, and Asian Pacific Islander borrowers. The finding was based primarily on a statistical analysis of loans using zip codes and names published by the Census Bureau as a proxy for determining whether borrowers were within the protected classes, notwithstanding the potential for obtaining inaccurate information by using such proxies.

The National City Order decision, which followed a two-year investigation by the CFPB of lending practices to evaluate compliance with fair lending laws, was also built on the Bureau’s finding of statistically significant discriminatory pricing disparities of retail mortgage loans and National City’s lending practices based on race and national origin.

These actions reflect the CFPB’s focus on fair lending practices, and examination of lenders using statistical analyses, including proxy analysis, to find and impose sanctions for ECOA violations.

DOJ and CFPB Team Up to Take on Auto and Mortgage Lenders

BY ELIZABETH BOHN





The Target Data Breach: Potential Consequences for Banks

BY PEDRO PAVÓN

The ultimate cost to Target of its recent data breach remains uncertain. So far, the company is the subject of several state investigations, a number of state and federal lawsuits, and a congressional probe into the incident. In 2007, when TJX Cos. (the parent company of T.J. Maxx, Marshalls, and other retailers) suffered a data breach, the estimated cost of the incident was about \$250 million. Considering scale and inflation, plus the rising cost of security and notification, the Target data breach is likely to cost much more.

Target has confirmed that at least 40 million credit and debit card accounts were affected by the breach. It has also confirmed that the names, phone numbers, and email and mailing addresses of up to 70 million additional customers were compromised.

While Target is a retailer, its data breach directly impacts the banking industry. Banks and retailers are currently debating which industry is most responsible for protecting customer data. Are retailers primarily responsible, and should they have implemented tighter security for processing payments? Or are the banks primarily responsible, and did they fail to implement modern security features on their credit and debit cards, such as the chip-and-pin features widely implemented in the European Union?

Regardless of how the debate is resolved, **consumer behavior will likely play a major role in dictating future responses by both the retail and financial sectors.** For example, consumers may stop shopping at retailers they deem “unsafe” or move their bank accounts to banks perceived to be on the cutting edge of security and privacy. Either way, both industries will have to work hard to safeguard consumer data and fend off future threats.

Supreme Court Helps Level the Playing Field for Patent Infringement Defendants

BY TY GILTINAN & ABIGAIL KORTZ

When facing a patent litigation threat, potential defendants have the option to seek a declaration that they are not infringing. Until recently, however, that strategy carried a hidden risk: the burden of proof on the infringement issue could shift to the accused infringer, instead of resting with the patentee. The Supreme Court has now mitigated that risk by holding that the patentee must carry the infringement burden, regardless of who brings the action.

In *Medtronic, Inc. v. Mirowski Family Ventures, LLC*, the Court held that “when a licensee seeks a declaratory judgment against a patentee to establish that there is no infringement, the burden of proving infringement remains with the patentee.” Mirowski accused its sub-licensee Medtronic of infringing patents relating to implantable heart stimulators, and Medtronic responded with a declaratory judgment action. After the trial court found Mirowski had failed to show infringement, Mirowski appealed, arguing that the burden was on Medtronic to show non-infringement since Medtronic brought the action. The Federal Circuit agreed, holding that, as a licensee and declaratory judgment plaintiff, the burden was Medtronic’s. The Supreme Court has now reversed, however, and confirmed that the burden remains on the patentee regardless of the form of the action.

Prior to *Medtronic*, it was not clear which party faced the burden on the infringement issue when a licensee brought a declaratory judgment action. That lack of clarity helped patentees by making declaratory judgment actions riskier. **Medtronic now levels the field somewhat by making it clear that the patentee must do the heavy lifting to show infringement, regardless of who commences litigation.** Some are concerned that licensees now have too much power to force the patentee into litigation. The Court reminded us, however, that the declaratory judgment action only arises when the patentee threatens litigation in the first place.



It May be Time to Update that Social Media Policy: FFIEC Releases Social Media Guidance

BY JONATHAN STERLING

On December 11, 2013, the Federal Financial Institutions Examination Council (FFIEC) released final supervisory guidance entitled “Social Media: Consumer Compliance Risk Management Guidance” (the Guidance). The Guidance became effective upon its release. The FFIEC is an interagency body for the following five federal regulatory agencies: Office of the Comptroller of the Currency (OCC); the Board of Governors of the Federal Reserve System; the Federal Deposit Insurance Corporation (FDIC); the National Credit Union Administration (NCUA); and the Consumer Financial Protection Bureau (CFPB) (collectively, Agencies). The FFIEC is empowered to prescribe uniform principles and standards for the examination of financial institutions and to make recommendations to promote uniformity in their supervision. The Agencies will use the Guidance in their supervision of institutions, and the FFIEC’s State Liaison Committee will encourage state regulators to adopt the Guidance.

The Guidance states that it does not impose any new requirements on financial institutions, but is designed as a guide to help financial institutions understand the applicability of existing requirements and supervisory expectations associated with social media use. The Guidance defines “social media” as any form of interactive online communication in which users can generate and share content through text, images, audio, and/or video. It notes that messages sent via traditional email or text message, standing alone, do not constitute social media, but messages sent through social media channels are considered social media.

The Guidance states that financial institutions should have a risk management program in place allowing them to identify, measure, monitor, and control the risks related to social media. The scope of the institution’s program should be commensurate with the breadth of its involvement in social media. The program should include a governance structure, policies and procedures for social media use, a risk management process for selecting and monitoring third party relationships in connection with social media, an employee training program, an oversight policy for monitoring information posted on proprietary social media sites, audit and compliance functions, and parameters for reporting to the board of directors or senior management to enable their periodic evaluations of the program.

The Guidance identifies three broad categories of social media risk: compliance and legal risk; reputational risk; and operational risk; and sets forth guidelines for managing each. With respect to compliance and legal risk, the Guidance establishes guidelines broken down by specific laws and regulations relating to deposit and lending products; payment systems; Bank Secrecy Act/Anti-Money Laundering; Community Reinvestment Act (CRA); and privacy. **Financial institutions are likely to find the compliance and legal risk section the most detailed, relevant, and instructive of the three broad categories.** The described reputational risks overlap somewhat with the compliance and legal risks category, and also include guidance for managing social media risk associated with fraud and brand identity, consumer complaints, and employee use of social media. The operational risk guidance is brief, and refers to previously-issued guidance.



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