EXPECT**FOCUS**®

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EXPECTFOCUS® Vol. I WINTER 2012

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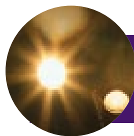

INTHESPOTLIGHT

Will Emerging Legislative Proposals Alter STOLI Landscape?

BY STEVEN KASS & DAWN WILLIAMS

Legislation has recently been introduced in a number of states (with more expected) that, if passed, would tilt the playing field in favor of life settlement and STOLI transactions. That proposed legislation, in its various formulations, essentially provides that **if a life insurance policy is alleged or deemed to be void or otherwise terminated for any reason other than nonpayment of premium, the policyowner shall have the right to recover all premiums paid, plus statutory interest.** The proposed legislation would also penalize insurers if they fail to confirm the existence of an insurable interest within a specified time period (e.g., in Florida, the policy would be deemed to be "void," triggering the refund right plus interest; in Minnesota, authorizing policyholder declaratory judgment actions, with costs and attorneys' fees, if a court determines the policy valid). The legislation, as proposed, would have retrospective application by applying to all in-force policies.

Proposed legislation likely to stir up debate

The proposed legislation is subject to criticism on both technical grounds (e.g., retrospective application, vagueness) and public policy grounds (e.g., circumvents existing insurable interest law, promotes STOLI transactions to the detriment of consumers). Industry trade groups, including the ACLI, have gone on record as opposing this legislation.

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No Let-Up in Sight

Continued Scrutiny of Unclaimed Benefits Practices

BY STEPHANIE FICHERA

All indications are that 2012 will bring continued scrutiny of insurers' unclaimed benefit practices. The recent activity includes:

Insurers increasingly expected to look more closely at unclaimed benefits

- **Legislative and Regulatory Initiatives –** Tennessee and Maryland introduced new legislation requiring insurers to compare their files against the Death Master File (DMF) to locate deceased insureds, annuitants and retained asset account (RAA) holders and to use good-faith efforts to locate beneficiaries and provide them with claims forms. Failure to do so would be an unfair claims settlement practice. Similarly, the New York Department of Financial Services' January 2012 Regulatory Agenda included an item to amend its Unfair Claims Settlement Practices regulation to require DMF cross-checks.

- **Unclaimed Property Audit Settlement –** Prudential Financial, Inc. entered into a settlement with 20 states following a Verus Financial LLC audit. Under the agreement, unclaimed benefits for life insurance policies, annuities, and RAAs in force at any time between January 1, 1992 and December 31, 2010 are escheatable to the states.

- **Stock Drop Litigation –** A lawsuit alleges that MetLife Inc. issued false and misleading statements concerning its financial condition in light of its potential liability for benefits that should have been, but were not, paid or escheated as a result of MetLife's alleged failure to use the DMF to identify payable life insurance benefits and RAA funds. The complaint alleges that MetLife's stock price was artificially inflated and fell once MetLife disclosed regulatory investigations that could result in additional escheatment of unclaimed benefits to states and increased its reserves.

- **Qui Tam Litigation –** A whistleblower action filed last year against MetLife and Prudential was unsealed by an Illinois judge. Total Asset Recovery Services, LLC (TARS) alleges that when the companies demutualized, many policyholders' demutualization payments were escheated to Illinois after the payments were returned to the companies. For the same policyholders, however, life insurance proceeds were not escheated. TARS claims that the companies failed to escheat more than $500 million in unclaimed benefits and seeks three times that amount in damages, at least $26 million in penalties, and recovery of 25-30% of the proceeds of the action. To date, Illinois has not joined in the suit.

Mark Your Calendar

The Insured Retirement Institute's Government, Legal & Regulatory Conference will once again feature a Litigation Track, co-sponsored by Jorden Burt. The conference will take place June 24-26, 2012 at the Omni Shoreham Hotel in Washington, DC. Please visit *www.irionline.org* for more information and registration.

Unpredictable Outcomes in California STOLI Cases

BY DAWN WILLIAMS

The Southern District of California recently denied a motion to dismiss an insurer's STOLI suit, indicating a willingness to look behind what might seem to be a legitimate transaction to find a lack of insurable interest. The order in *PHL Variable Ins. Co. v. Abrams* thus adds to a growing line of authority that is anything but straight: **although an early federal opinion in California (*Fishman*) was unfavorable for insurers, the most recent federal cases, including *Abrams*, have indicated that California district courts may find policies procured through STOLI schemes to be void**. The *Abrams* court relied on the post-*Fishman* federal jurisprudence to find that if the trust is acting as a straw man to carry out a STOLI scheme, the policy may be void due to a lack of insurable interest.

Recent STOLI decisions confound

That opinion stands in stark contrast to a relatively recent unpublished California Court of Appeal decision (*Berck)* reversing the trial court's determination that the STOLI policies in that case were void. That court cited *Fishman* extensively and concluded that as long as an insurable interest existed at inception, the policy would not be void, even though there was a clear intent to transfer ownership. Refusing to "look behind the terms and other formalities of an insurance agreement," the court, however, noted that the outcome would likely be different under 2009 amendments to California law.

Due to such contradictory conclusions – with some courts accepting a facially plausible insurance application and others looking behind the documents to review the intent of the transaction – the outcome of any particular STOLI case in California is unpredictable and may hinge on which line of authority the court finds the most persuasive.

Class Certification Vacated in Long-Running "Revenue Sharing" Case

BY BEN SEESSEL

The Second Circuit Court of Appeals vacated a Connecticut federal district court order certifying a class of 401(k) plan trustees in *Haddock v. Nationwide Life Ins. Co.* The suit, which has been pending since 2001, alleges that Nationwide breached purported ERISA fiduciary duties by receiving and retaining so-called "revenue sharing" payments from advisers or other affiliates of mutual funds that were offered as investment options under Nationwide group annuity contracts issued to ERISA-governed retirement plans or their participants. In 2009, the district court certified a "hybrid" class of over 24,000 plan trustees under Rule 23(b)(2), permitting notice and opt-out rights for class members. The district court, however, did not address plaintiffs' alternative request for Rule 23(b)(3) certification. After accepting the immediate appeal by Nationwide, the Second Circuit on February 6, 2012 vacated the district court's certification order.

The Second Circuit based its decision on the Supreme Court's decision in *Wal-Mart Stores, Inc. v. Dukes,* which had not been decided when the district court granted class certification. The Supreme Court in *Wal-Mart* held that claims for individualized monetary damages preclude class certification under Rule 23(b)(2) unless such damages are truly "incidental" to the requested declaratory or injunctive relief. The Second Circuit determined that, **if plaintiffs were successful in establishing that Nationwide was liable for disgorgement, "the district court would then need to determine the separate monetary recoveries to which individual plaintiffs are entitled"** and that **this process would "require the type of non-incidental, individualized proceedings for monetary awards that *Wal-Mart* rejected under Rule 23(b)(2)."** Based on the Second Circuit's ruling, the district court should be limited to considering certification under the more stringent requirements of Rule 23(b)(3). Jorden Burt represented the ACLI as *amicus curiae* in support of Nationwide and in favor of reversal of the district court's certification order.

NAIC Working Groups Update

BY STEVEN KASS

Following the NAIC 2011 National Fall meeting, three working groups are examining a number of life insurer practices and products.

A joint "A" & "E" Committee Working Group is addressing insurers' reserving practices under Actuarial Guideline 38 for Universal Life with Secondary Guarantees and Term UL products. It has been considering whether interim guidelines or tools are warranted pending the final adoption of a Valuation Manual under the NAIC's Principle-Based Reserving initiative. On January 13, 2012, the Working Group issued a draft "Framework," identifying implementation issues and key process decisions. The Framework envisions a separate approach for inforce business and new business. Inforce business would be treated as a closed block, which would be subject to a stand-alone asset adequacy analysis. New business would be subject to reserve requirements using a formulaic approach consistent with the Life Actuarial Task Force's controversial interpretation of AG 38 in determining appropriate reserves for shadow account design products.

Show Your Work: NAIC examines insurers' reserving/valuation procedures

The Contingent Deferred Annuity (A) Subgroup is studying stand-alone guaranteed lifetime benefits (CDAs) and the issues raised by the Life Actuarial Task Force referral. After reviewing the American Academy of Actuaries Contingent Annuity Working Group analysis and a historical analysis, the Subgroup believed that carriers issuing CDAs assumed market risk as well as longevity risk. It could not conclude that CDAs are "annuities." At its February 16, 2012 meeting, the Subgroup opted to call CDAs a "synthetic hybrid income annuity" (SHIAs) and also classified guaranteed lifetime withdrawal benefit riders added to a variable annuity as a "hybrid income annuity" (HIAs). The Subgroup found that HIAs and SHIAs should be regulated similarly and acknowledged that regulation already existed for HIAs. The Subgroup intends to recommend that a new working group review the regulation of HIAs and consider whether the regulation sufficiently addresses solvency and consumer protection issues, and then consider what changes are needed to bring SHIAs within the same regulatory framework.

The Receivership Separate Accounts (E) Working Group has been addressing the use of separate accounts for non-variable products. It has focused on gathering more information and is proposing changes to life insurance and separate account blanks to elicit additional information on carriers' separate accounts. The changes would seek information as to whether a separate account is insulated or non-insulated from general creditors, each product funded by the separate account, and whether there are guarantees of the general account associated with each product.

Federal District Court Remands Finding on SLUSA Preemption

BY DAWN WILLIAMS

The federal district court in New Jersey recently remanded a putative class case based on annuity sales to state court in *Stephens v. Gentilello*. Having purchased an annuity with a guaranteed income benefit (GIB) rider, plaintiff alleged that defendants negligently failed to attach the rider to her policy. The case bounced between state and federal court, and two years after the action was originally brought, the defendants attempted to remove for a second time based on SLUSA. The operative complaint did not plead fraud, but defendants claimed SLUSA preemption based on plaintiff's own deposition testimony wherein she articulated her claim as arising from defendants' alleged "lies" and "intentional misstatements."

The court found that where misrepresentations serve as a factual predicate to the plaintiffs' claim, removal under SLUSA is proper, but where they are "merely background details that need not have been alleged, and need not be proved," SLUSA will not preempt the plaintiffs' claims. **To be a factual predicate, the court explained, the misrepresentation must give rise to liability and not merely be an extraneous detail.** The court found that the misrepresentations in this case were immaterial to whether the defendants negligently failed to include the GIB rider, and so remanded.

Second Circuit Addresses Effect of Class Settlements on Right to Arbitrate

BY JONATHAN HART

The Second Circuit Court of Appeals recently addressed "several unsettled issues concerning the effect of a class-action settlement on an individual class member's preexisting right to arbitrate certain claims." In *In re American Express Financial Advisors Securities Litigation*, the claimants brought various claims before FINRA alleging that Ameriprise failed to properly manage their assets. Ameriprise moved to stay the arbitration arguing that the claimants' claims had been released in a prior class action settlement in the Southern District of New York. After FINRA arbitrators denied the motion, Ameriprise sought and obtained from the district court, which had retained exclusive jurisdiction over the Settlement, an order requiring dismissal of the claimants' FINRA complaint.

Second Circuit: Settlement amends "contours" of arbitration agreement

On appeal, the court found that the claimants were bound by the settlement, noting that the Class Notice was "reasonably straightforward" and the failure to opt out of the Settlement was not the product of "excusable neglect." The court rejected the argument that the arbitrators should decide the scope of the settlement, explaining that **the issue was not merely whether the claims had been resolved, but whether the settlement revoked Ameriprise's consent to arbitrate, and therefore it was a "question of arbitrability" within the purview of the court**. Finally, the court determined sua sponte that the federal courts, independent of the All Writs Act, "may properly enjoin arbitration proceedings that are not covered by a valid and binding arbitration agreement."

The court concluded that the settlement "amended the contours of the parties' agreement to arbitrate" and "extinguished" the class members' "right" to arbitrate released claims. Therefore, the district court did not err by enjoining arbitration proceedings for claims covered by the release in the settlement.

Scribner, Hall & Thompson, LLP

IRS Limits Penalty-Free Distributions from Annuities

BY KEVIN LEFTWICH

In PLR 201120011 (May 20, 2011), the IRS ruled last year that a series of payments from an annuity contract that escalate annually at a fixed rate do not qualify as "substantially equal periodic payments" (SEPPs), and are not excepted from the 10% penalty for early distributions from an annuity contract under I.R.C. § 72(q). In early guidance, the IRS provided three payment methods that would qualify as SEPPs, one of which was using a method acceptable for purposes of the required minimum distribution (RMD) rules for retirement plans. See Notice 89-25, 1989-1 C.B. 662, and I.R.C. § 401(a)(9). The PLR taxpayer looked to this language, arguing that the escalating payments qualified as SEPPs because they satisfy the RMD rules. The IRS interpreted subsequent guidance on SEPPs narrowly, noting that it modifies the prior guidance and describes only one of the methods that meets the RMD rules (i.e., where the payment amount is calculated by dividing the remaining account balance by the current life expectancy). See Rev. Rul. 2002-62, 2002-2 C.B. 710; and Notice 2004-15, 2004-1 C.B. 526.

The SEPPs exception, which allows penalty-free payment stream from annuity contracts prior to age 59 ½ as long as the payments are substantially equal and are for life (or life expectancy) of the owner is consistent with the tax policy behind income-recognition deferral for annuity contracts, i.e., to provide income for retirement, because the payments are extended through the owner's life to address the risk that the retiree will outlive his savings. An escalating stream of payments for life effectively backloads the payments (relative to a non-escalating stream), resulting in smaller payments in early years before age 59 ½ and larger payments later in retirement. The IRS's narrow interpretation disallows a payment stream that arguably is more consistent than the level payment stream with the tax policy underlying the SEPPs exception.

Sixth Circuit Affirms Grant of Motion to Strike Class Claims

BY JOHN BLACK & W. GLENN MERTEN

In affirming a decision to grant a defendant's motion to strike class claims prior to any motion for class certification, the Sixth Circuit Court of Appeals recently demonstrated the potential benefits to defendants of challenging class certification early and aggressively. In *Pilgrim v. Universal Health Card, LLC*, plaintiffs filed a putative nationwide class action in federal court in Ohio alleging that Universal Health Card and Coverdell & Company misrepresented a program designed to provide healthcare discounts to consumers. Before the plaintiffs moved to certify a class, Universal Health filed a motion to strike the class allegations. The district court granted the motion on the grounds that each putative class member's claims must be analyzed under the laws of his or her home state, and "such a task … would be unmanageable as a class action." The trial court also dismissed the action without prejudice due to lack of federal subject matter jurisdiction.

The Sixth Circuit upheld the district court's decision for three reasons. First, Ohio's choice-of-law rules dictated that different states' laws would govern the class members' claims. Accordingly, the plaintiffs could not satisfy the predominance requirement of Rule 23(b)(3). Second, potential common issues of fact could not "overcome this problem," and the court noted that the claims did not include a "considerable factual overlap." Third, the decision was consistent with Sixth (as well as Third, Fifth, Seventh, and Ninth) Circuit precedent.

The court emphasized that since Rule 23 requires a district court to decide whether to certify a class at "an early practicable time," and **nothing in the rule requires that the plaintiff initiate the inquiry, Universal Health's preemptive motion was not premature**. The court noted, however, that such a procedural right did not change the "rigorous analysis" required by Rule 23 and existing case law.

Is Insurer's Use of Retained Asset Accounts a Breach of ERISA Fiduciary Duties?

BY STEPHANIE FICHERA

In two recent opinions, federal district courts came to conflicting conclusions on the issue of whether insurers of ERISA-governed employee welfare benefit plans breached their fiduciary duties when they retained and invested for their own profit the funds backing retained asset accounts (RAAs). Plaintiffs in these actions alleged that the insurers breached their fiduciary duties under ERISA Sections 404(a) and 406(b).

In *Edmonson v. Lincoln National Life Insurance Company*, a putative class action, the Eastern District of Pennsylvania granted summary judgment in favor of the insurer, holding that Lincoln did not act as a fiduciary when it held and invested the funds backing plaintiff's RAA. According to the court, **once Lincoln established the RAA and a checkbook was issued, the company shifted control of the account's proceeds to the plaintiff, Lincoln's fiduciary obligations were discharged**, and its remaining obligations — to honor plaintiff's checks and pay interest on her account at a specified rate — were merely administrative and ministerial. Moreover, the court held that Lincoln did not breach its fiduciary duties under Section 406(b) because the funds backing plaintiff's account were not plan assets under ERISA. The decision was recently appealed to the Third Circuit Court of Appeals.

In another putative class action, *Merrimon v. Unum Life Insurance Company of America*, the District of Maine also held that the funds backing RAAs were not plan assets, but ruled, nevertheless, that Unum acted as a fiduciary under ERISA Section 404(a) in setting the interest rates for the RAAs suggesting the company may have managed the RAAs to optimize its earnings. The court emphasized, however, "that the RAA method of payment itself is not necessarily inconsistent with ERISA." In the same decision, the court certified the case as a class action with respect to plaintiffs' remaining 404(a) claim, but rejected plaintiffs' state-law breach of contract and late-payment claims, finding that payment by RAA was a timely payment under the policies.

Chinese Drywall Update

Recent Florida Decisions Uphold Policy Exclusions Barring Chinese Drywall Claims

BY IRMA REBOSO SOLARES

Two recent Florida district court decisions have sided with insurers, holding that they have no duty to defend or indemnify their insureds for Chinese drywall claims. In *Colony Insurance Co. v. Total Constructing*, the insurer filed suit seeking a declaration against a general contractor and homeowners that it owed no duty to indemnify the homebuilder for claims stemming from the installation of defective Chinese drywall. The homeowners claimed that they suffered personal and property damage as a result of sulfides and other noxious gasses released from the Chinese-manufactured drywall. The commercial general liability (CGL) policies issued to the homebuilder each contain a "hazardous materials" provision which expressly excludes coverage for hazardous materials, pollutants and irritants. On summary judgment, the Southern District court concluded that claims asserted by the homeowners fell squarely within the exclusionary language of the policy, and the insurer had no duty to defend or indemnify the homebuilder.

The Middle District court in *Granite State Insurance Co. v. American Building Materials, Inc.* (M.D. Florida) similarly held that a "total pollution exclusion" in the CGL policy issued to American Building Materials (ABM) "unambiguously" precluded coverage for claims arising from the sale of defective Chinese drywall. The pollution exclusion clause barred damage caused by the "discharge, dispersal, seepage, migration, release or escape of 'pollutants' at any time." Granite moved for entry of a declaratory judgment that it had no duty to defend or indemnify its insured, a drywall supplier, or the builder named as an additional insured under the policy. The court granted summary judgment to the insurer, holding that **an "objectively reasonable insured" would not have expected that damage caused by defective Chinese drywall**, which allegedly emitted harmful gasses and caused personal and property damage, would be covered under the policies.

Coverage for "Allocated Loss Expense" Includes Attorneys' Fees

BY JOHN PITBLADO

Federal Insurance Company and Zurich American Insurance Company were parties to a co-surety agreement providing excess professional liability coverage to the Hartford Financial Services Group. An endorsement designated Federal as the "Controlling Company" with respect to the investigation and adjustment of Hartford's claims and provided that both parties "shall be liable for their proportionate share of allocated loss expense incurred by [Federal] associated with any claim made under the policy."

Having settled a class action claim against it, Hartford sought coverage under the co-surety agreement. Federal contested coverage and initiated an arbitration in Bermuda. The arbitration panel found in Hartford's favor, and ordered Federal to pay $3.5 million in attorneys' fees and costs incurred by Hartford in the coverage dispute. Federal looked to Zurich to contribute its proportionate share of the $3.5 million as an "allocated loss expense." Zurich declined and Federal initiated a coverage action in federal court.

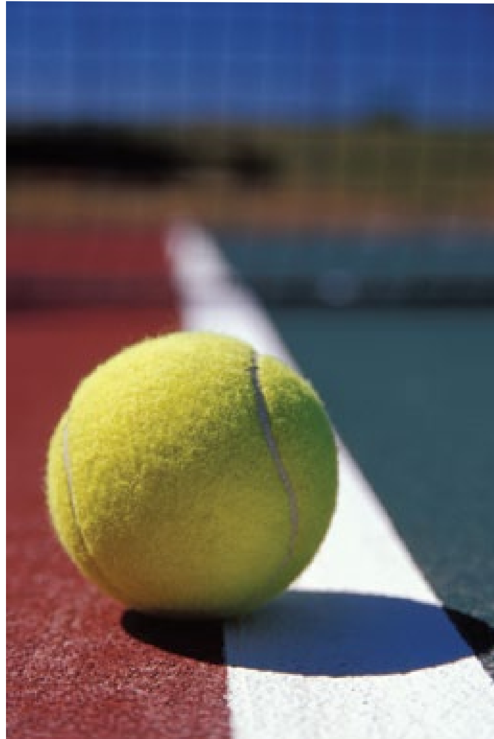
Based on the parties' letter to the court indicating that they considered discovery unnecessary and the dispute to be ripe for summary judgment, and after some further letter briefing by both parties, the court granted summary judgment to Federal sua sponte.

Zurich appealed, arguing both procedural impropriety by the court's sua sponte grant of summary judgment, and that the court misinterpreted the policy. The Second Circuit Court of Appeals affirmed, however, noting that **trial courts have discretion to enter summary judgment sua sponte, so long as it is not an "unfair surprise."** It also affirmed the trial court's analysis of the undefined policy term "allocated loss expense," finding that the term "allocated" modified "loss expense," and that the attorney's fees and costs were allocable to the loss at issue, and therefore a covered expense for which Zurich owed reimbursement.

Court Won't Budge
Obtaining Intra-Panel Emails Was Out-of-Bounds

BY BEN SEESSEL

A federal district court has denied Insco's motion for reconsideration of the court's order disqualifying Insco Ltd.'s counsel from further representing it in a pending reinsurance arbitration. The basis for the disqualification was counsel's procurement of intra-panel e-mails from Insco's appointed arbitrator and failure to produce the e-mails in discovery.



Insco's counsel had requested the communications to substantiate allegations that opponent Northwestern National Insurance Company's appointed arbitrator was biased. In a prior order, the court denied Insco's request to submit a declaration by one of its attorneys in support of its motion for reconsideration, finding that nothing in the declaration raised new arguments or facts that had not been raised by Insco in opposition to Northwestern National's motion to disqualify. After determining that the court, and not the arbitration panel, should determine issues of attorney discipline, the court had held that Insco's counsel's actions constituted "a serious violation of arbitral guidelines, as well as ethical rules."

In denying Insco's motion for reconsideration, the court reiterated its conclusions that counsel acted inappropriately by obtaining the intra-panel e-mails and subsequently ignoring a discovery request seeking their production. The court also restated that **counsel's receipt of the e-mails tainted the underlying proceedings because while the e-mails did not reveal in detail "the arbitrators opinions on dispositive issues," they nevertheless related to the subject matter of the arbitration, including ongoing disputes in the proceeding**. Insco filed a notice of appeal and a motion to stay pending appeal. The district court's extensive order acknowledged that the disqualification would prejudice Insco, but defended its prior decisions and denied the motion to stay, meaning that the arbitration should proceed during the appeal with new counsel for Insco.

English Court Says Expert May Testify Against Former Client

BY MICHAEL WOLGIN

An English court has allowed an expert witness to give testimony against a Lloyd's syndicate, despite that expert's previous engagement by the syndicate in an arbitration with a different party, but involving similar issues. The subject of the expert's testimony in this case related to the extent of coverage for losses arising from the 9/11 terrorist attacks under a reinsurance "Interlocking Clause." Although the expert's previous testimony on behalf of the syndicate did not involve the Interlocking Clause, the interpretation of that clause did arise in private meetings wherein the expert expressed disagreement with the syndicate's interpretation. When the syndicate's opponent in the later case engaged the expert to give testimony on the Interlocking Clause, the syndicate unsuccessfully sought to exclude the expert, then sought injunctive relief.

The Queen's Bench Commercial Court in *A Lloyd's Syndicate v. X* rejected the syndicate's argument that the expert unfairly possessed confidential information, including the syndicate's potential cross-examination strategy. The court explained that there was **no evidence that the expert had misused confidential information thus far, and that the expert's alleged inability to recall details of the syndicate's meetings rendered it unlikely that the expert would do so in the future**. To the extent the syndicate lost the element of surprise with respect to its cross-examination strategy, the court was "not persuaded that the loss of such a forensic advantage amounts to damage which justifies the grant of an injunction which would interfere with the tribunal's management of the arbitration."

Cedent Sues Over Absence of Required Security

BY ANTHONY CICCHETTI & MICHAEL WOLGIN

A cedent life insurer's complaint that reinsurers failed to maintain a trust account comprising required reserves has survived dismissal. Security Life Insurance Company of America had entered into a number of arrangements with producer-owned reinsurance companies (PORCs) and their organizer/administrator, Southwest Reinsure, Inc. (SRI). The arrangements included various reinsurance agreements between Security Life and the PORCs, and a services agreement between Security Life and SRI for administration by SRI of the reinsured business.

Parties' course of dealing can alter the terms of a reinsurance agreement

The reinsurance agreements required the PORCs to pay Security Life a fee to cover any deficiency in Security Life's reserves account. When a deficiency arose, SRI arranged for a letter of credit in lieu of the fee and, subsequently, the creation of a trust account. SRI allegedly transferred the trust to another bank without Security Life's knowledge, and ultimately depleted the account. **Alleging that it consequently could not use the account to meet its statutory capital requirements**, **Security Life filed suit** for breach of contract, breach of fiduciary duties, fraud, and conversion, among other counts.

The court found that factual questions existed as to whether the agreement had been modified by the parties' course of dealing, namely, that the parties would use letters of credit and a trust account in lieu of charging and paying fees. **The court concluded that Security Life's alleged damages based on risk of "adverse regulatory action" or downgraded rating were not too speculative to bar recovery.** The fraud and fiduciary duty counts also survived, with the court finding as to the latter that "the complex relationships … call into question the arm's length nature of the various agreements between the parties." Security Life's claim for conversion failed, however, because it did not allege an immediate right to possess the funds in the trust account.

Update on Reinsurance Collateral Initiatives

BY ANTHONY CICCHETTI

On November 6, 2011, the National Association of Insurance Commissioners adopted revisions to the NAIC Credit for Reinsurance Model Law (#785) and Credit for Reinsurance Model Regulation (#786). A detailed discussion of the revised models is available in a *Special Focus* feature on Jorden Burt's reinsurance and arbitration blog, *ReinsuranceFocus.com*.

On December 13, 2011, the Florida Office of Insurance Regulation approved Platinum Underwriters Bermuda, Ltd., as the 18th reinsurer to operate in Florida as an eligible reinsurer under reduced collateral requirements. The New York Department of Financial Services, Insurance Division, reports that New York has certified 19 reinsurers for reduced collateral reinsurance writing.

Are Fund Advisers Out of the Woods After Janus?

BY GARY COHEN

In the U.S. Supreme Court's recent decision, *Janus Capital Group, Inc. v. First Derivative Traders*, the Court observed that a fund is a legally separate entity with a board of directors exercising ultimate control over the prospectus; therefore, the fund – not the adviser preparing the prospectus – makes the statement in the fund's prospectus for purposes of Rule 10b-5(b) liability. Plaintiffs and defendants alike have cause to ask what approaches can and are likely to be used to impose liability on secondary actors, like fund advisers, for alleged prospectus misstatements.

Janus leaves uncertainty for both plaintiffs and defendants

Most early indications are that plaintiffs are pursuing alternative approaches, although not involving fund advisers. Plaintiffs could, however, conceivably follow that approach where alleged misstatements are, in fact, traceable to advisers. Otherwise, one potential alternative approach is to ask courts to pierce the corporate veil and hold defendants liable under an alter ego theory. However, this approach may be precluded by the *Janus* Court's refusal to accept the "invitation to disregard the corporate form."

Plaintiffs may also seek to impose "control person" liability under Section 20(a) of the Securities Exchange Act, but this strategy may be futile, because a plaintiff must prove a primary violation by a fund before the plaintiff could prove secondary liability for the adviser. If a fund were unaware that its prospectus contained a misstatement, it would likely lack the scienter necessary to establish primary violator liability. A third approach – to ask courts to find fraudulent scheme liability under Rule 10b-5(a) or deceptive practice liability under Rule 10b-5(c) – would have to overcome the Supreme Court's determination in *Janus* that there is "no reason to treat" Rule 10b-5(a), (b) and (c) "differently" in this regard.

Outlook Cloudy for Investment Adviser SRO

BY SCOTT SHINE

Legislation transferring investment adviser examination responsibilities from the SEC to one or more self-regulatory organizations (SROs) has been delayed, reportedly due to a desire to further consider certain potential objections to the SRO model.

Waiting for a resolution? Don't watch the clock.

In September 2011, Congressman Spencer Bachus, Chairman of the House Financial Services Committee and a principal proponent of the SRO model, released draft legislation that would require certain types of investment advisers to be SRO members. Although many expected such legislation to be formally introduced by now, it still appears likely that Congressman Bachus will introduce a bill later this year.

Even critics of the SRO model acknowledge the need to ramp up adviser examination frequency. However, they point to a recent industry-sponsored report by Boston Consulting Group estimating that investment adviser examinations by an SRO, under the SEC's oversight, would cost more than twice as much as providing the SEC with additional funding to conduct such examinations directly. Others dispute this conclusion.

Arguments also continue to swirl about **whether FINRA, if it becomes an SRO for investment advisers, would have the expertise and motivation to effectively and fairly enforce the fiduciary-duty standard** to which advisers must adhere. In addition, at a hearing on Congressman Bachus' draft legislation, state securities regulators voiced concerns that an SRO might undermine their role.

The SRO model faces other important opposition, including from much of the financial planning industry, as well as from Congressman Barney Frank, who instead favors providing the SEC with more funds to conduct examinations directly. While it still seems most likely that Congress will ultimately require an SRO for investment advisers, Frank, the ranking member on the House Financial Services Committee, will be in a position to make this more difficult until he retires at the end of this year.

Judges Refuse to Rubber Stamp SEC Settlements

BY TOM LAUERMAN

U.S. District Court Judge Jed Rakoff, in the Southern District of New York, recently made news by rejecting a proposed settlement between the SEC and Citigroup Inc. Rakoff believed that the SEC's customary practice of allowing the defendant to enter into a consent judgment without admitting or denying the underlying allegations deprived the court of a sufficient factual basis to conclude whether or not the settlement was in the public interest. The judge characterized the proposed settlement as imposing on Citigroup only:

- A "modest" penalty of $95 million (plus disgorgement of $190 million profits and interest thereon);
- Injunctive relief of a sort that the SEC has "not sought to enforce against any financial institution for at least the last 10 years"; and
- Certain "relatively inexpensive prophylactic measures."

In these and other respects, **Judge Rakoff was concerned that the settlement might be too favorable to Citigroup and insufficiently beneficial to investors who were allegedly damaged by Citigroup's conduct.** Based on similar concerns, Rakoff also had previously rejected a proposed settlement between the SEC and Bank of America. There, the parties subsequently renegotiated the terms of the settlement, which the judge even then approved only reluctantly.

U.S. District Court Judge Rudolph Randa, in the Eastern District of Wisconsin, has recently expressed concerns similar to Judge Rakoff's, citing the Citigroup and Bank of America cases. In connection with a proposed settlement between the SEC and the Kloss Corporation, Judge Randa requested the SEC to provide the court with "a written factual predicate for why it believes the court should find that the proposed [settlement] … in the public interest."

For a discussion of the implications of judges' refusal to rubber stamp SEC settlements, see "SEC Enforcement Evolves" below.

SEC Enforcement Evolves

BY TOM LAUERMAN

Federal judges seem to have grown less willing to uncritically approve SEC settlements on terms that have been common in the past. Any such trend could have important consequences. For example, to the extent that courts will not approve settlements in which the defendants do not admit wrongdoing, the SEC will find settlement much more difficult (and in many cases impossible). This could require more litigation, thus straining the SEC's resources.

Opinions differ whether the potential benefits of enhanced judicial scrutiny of SEC settlements would outweigh the potential adverse consequences. The Director of the SEC's Enforcement Decision, for example, has strongly criticized Judge Rakoff's recent rejection of the SEC's proposed settlement with Citigroup. See *"Judges Refuse to Rubber Stamp SEC Settlements"* above. In addition, the SEC has requested the Second Circuit Court of Appeals to review Judge Rakoff's determination.

If faced with the prospect of having to litigate more cases, the SEC might instead seek to posture more enforcement matters as administrative proceedings. Indeed, the Dodd-Frank legislation already has encouraged such proceedings by augmenting the SEC's administrative enforcement powers, and the SEC is requesting that Congress enact further enhancements. Specifically, the SEC is requesting that Congress raise the generally-applicable maximum for civil penalties in administrative actions from $150,000 to $1,000,000 per violation for individuals and from $750,000 to $10,000,000 per violation for companies.

Even in the absence of any enhanced judicial scrutiny of SEC settlements, the SEC probably will be increasing its reliance on administrative proceedings, as compared with court cases. This certainly should give some pause to potential defendants, bearing in mind that, in an administrative action, the SEC not only writes the rules, but also acts as prosecutor, judge, and jury.

Ruling on Martin Act Preemption Portends Sea-Change

BY BEN SEESSEL

The New York Court of Appeals has held in *Assured Guaranty (UK) Ltd. v. J.P. Morgan Investment Management* that the Martin Act, New York's "blue sky" law, does not preempt private common-law claims relating to securities transactions. New York federal district judges frequently had dismissed such claims (other than those involving scienter) as being preempted by the Martin Act. Although the Martin Act authorizes the New York Attorney General to pursue even conduct that does not involve scienter, it does not provide any private right of action for such claims. **The New York high court's decision thus deprives defendants of a powerful weapon in defending securities cases by private plaintiffs, one that often yielded dismissal of state common-law claims at the pleadings stage**.

Securities defendants defenseless in New York?

In *Assured Guaranty*, plaintiff alleged that investment manager J.P. Morgan committed breach of fiduciary duty, gross negligence, and breach of contract by over-exposing a reinsurer's reserves to mortgage-backed securities. The trial court granted J.P. Morgan's motion to dismiss the breach of fiduciary duty and gross negligence claims based on Martin Act preemption. The Appellate Division modified the dismissal by reinstating the breach of fiduciary duty and gross negligence claims.

The Court of Appeals affirmed the Appellate Division's decision, reasoning that nothing in the text of the Martin Act precludes common-law claims and that, where a common-law remedy exists and another is provided by statute, the remedies are taken to be cumulative unless the statute indicates otherwise. The court also concluded that the purpose of the Martin Act, combating fraudulent or deceptive securities transactions, was not hindered by allowing private actions. The court stated that, on the contrary, preemption of common-law claims would leave investors less protected than they were when the Martin Act was passed.

SEC Radar Targets Proxy Voting Advice

BY MARILYN SPONZO

Enhanced regulation of proxy advisory firms will likely be on the SEC's 2012 agenda, according to Division of Corporation Finance Director Meredith Cross. Speaking at a recent Practising Law Institute conference on securities regulation, Cross noted that the SEC staff has been examining the role of proxy advisory firms in shaping shareholder votes and may address potential problems through interpretive guidance and/or regulation.

Proxy advisory firms provide investment advisers and institutional investors with analyses and recommendations on matters appearing on an issuer's proxy. Additionally, these firms may provide consulting services to issuers regarding corporate governance or executive compensation proposals, and some firms also qualitatively rate issuers on corporate governance matters. In some cases, proxy advisory firms may issue voting recommendations on issuers to whom they also provide consulting and rating services.

Proxy advisory firms are generally subject to the proxy rules under the Exchange Act, and many are federally registered as investment advisers. Nonetheless, in its 2010 "proxy plumbing" release, the SEC expressed concern that proxy advisory firms may: have conflicts of interest that are insufficiently disclosed and managed; use inaccurate information in formulating voting recommendations; and lack appropriate oversight of their control and influence on shareholder voting.

Among the possible changes the SEC has suggested to address these concerns are making more proxy advisory firms subject to certain provisions of the Exchange Act's proxy rules and/or subject to registration under the Investment Advisers Act. Additionally, **the SEC has analogized the activities of proxy advisory firms to those of credit rating agencies**, and has suggested that proxy advisory firms may benefit from regulations similar to those addressing conflicts of interest by nationally recognized statistical rating organizations.

SEC Regulation D Catches Up to the Law

BY ED ZAHAREWICZ

Effective February 27, 2012, the SEC has adopted final rule amendments to Regulation D and Rule 215 under the Securities Act of 1933 to conform the rules' definition of accredited investor to the requirements of the Dodd-Frank Act.

SEC: Keeping pace with Dodd-Frank

Dodd-Frank requires that the value of a person's primary residence no longer be counted for purposes of determining whether the person qualifies as an accredited investor on the basis of having, individually or jointly with a spouse, a net worth in excess of $1 million. The SEC staff took the position that this change became effective automatically on July 21, 2010 upon Dodd-Frank's enactment. The final rule amendments also formalize a related SEC staff interpretation that any indebtedness secured by the primary residence, up to the estimated fair market value of the residence, is not counted as a liability in determining accredited investor status. However, any such indebtedness in excess of residence's fair market value must be included as a liability.

In addition, the final rule amendments add a requirement that, if indebtedness secured by the primary residence increases within 60 days prior to the purchase of a security in reliance on the rule (other than for the acquisition of the residence), the increase must be included as a liability. Lastly, the final amendments add a limited grandfathering provision under which the former net worth standard will apply in connection with purchases of securities pursuant to a right held by a person on July 20, 2010, if (i) the person qualified as an accredited investor on the basis of net worth at the time the right was acquired, and (ii) the person held securities of the same issuer, other than the right, on July 20, 2010.

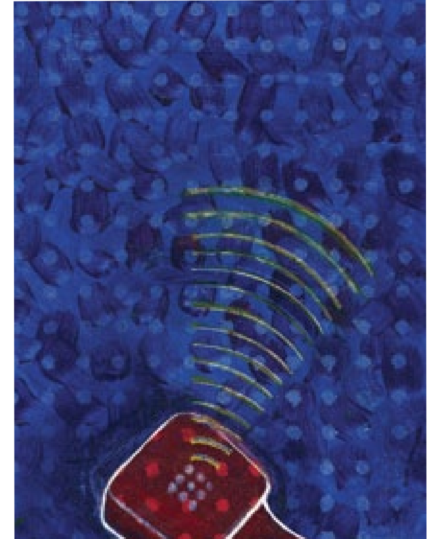
Congratulations!

Seven Jorden Burt attorneys were selected to be on the DC Court of Appeals and DC Superior Court's Pro Bono Honor Roll: **Sheila Carpenter** (High Honor), **Rollie Goss** (High Honor), **Jason Morris** (High Honor), **Brian Perryman, Kristin Reilly, Dawn Williams** and **Todd Willis.**

Supreme Court Rules Federal Courts May Hear TCPA Claims

BY ELIZABETH BOHN

Congress enacted the Telephone Consumer Protection Act (TCPA) to provide a framework for federal regulation of intrusive telemarketing calls. The Act authorizes the FCC to regulate interstate and intrastate telemarketing, and the National Do Not Call List was created as a result. Although initially concerned with regulating telemarketing calls, as use of automated dialing system (ADS) and prerecorded message (PM) technology has expanded, so has application of the TCPA to other businesses using such technology in calling consumers. Thus, subject to certain exemptions, **the TCPA prohibits the use, without prior express consent, of an ADS or PM to call a consumer's cellular phone, and also restricts such calls to land line phones**.



TCPA prohibitions on sales calls expanding to various businesses

In addition to empowering the FCC and the state Attorneys General to enforce it, the TCPA authorizes individual and class action suits, imposing strict liability for violators and providing statutory penalties from $500 (non-willful) to $1,500 (willful) per violation/call, as well as injunctive and declaratory relief.

Language in the TCPA stating that private actions may be brought in "an appropriate court of that State," has been interpreted by several federal courts of appeal as conferring exclusive jurisdiction upon state courts to hear such claims. For example, in *Mims v. Arrow Financial Services, Inc.*, the Eleventh Circuit Court of Appeals affirmed dismissal for lack of jurisdiction of a consumer's claims for a debt collection agency's alleged multiple violations of the TCPA.

On January 18, 2012, the Supreme Court reversed the Eleventh Circuit's decision in *Mims*, and held that the TCPA's grant of jurisdiction to state courts was permissive and did not deprive district courts of federal question jurisdiction. Thereby, the Court eliminated lack of jurisdiction as the complete defense to a TCPA claim as it had been in the Eleventh and other federal circuits.

Attorney Misconduct Sinks Class Certification

BY JASON KAIRALLA

In *Creative Montessori Learning Centers v. Ashford Gear LLC* (Nov. 22, 2011), the Seventh Circuit, in an opinion by Judge Posner, vacated an order granting class certification because attorney misconduct rendered plaintiff's counsel inadequate to represent the class. The putative class action brought under the Telephone Consumer Protection Act involved a defendant allegedly responsible for nearly 15,000 unsolicited fax advertisements. The plaintiff's lawyers obtained information about the defendant's faxes from a fax broadcasting company, which provided the information in exchange for a promise of confidentiality. The lawyers identified the eventual plaintiff from that information and, in communicating with the plaintiff, represented that the class action was ongoing. Only later did they sign up the plaintiff and file suit on its behalf.

The district judge expressed concern regarding the lawyers' conduct – *i.e.*, breaching the confidentiality arrangement and misrepresenting the status of the case to their prospective client – but ultimately certified the class after concluding that "only the most egregious [attorney] misconduct" would be grounds for denial of class certification. The Seventh Circuit rejected the district court's standard and held instead that **any misconduct which casts "serious doubt" on class counsels' loyalty is grounds for denial of certification**. The court remanded for reevaluation of class counsels' Rule 23(a)(4) adequacy under the announced standard.

Consumer Financial Protection Bureau Update

BY ELIZABETH BOHN

Nonbank Supervision Begins

The CFPB is getting down to business

The Consumer Finance Protection Bureau announced in December that it would begin supervision of non-banks, i.e., non-depository businesses which offer or provide consumer financial products or services but do not have a bank, thrift, or credit union charter. Dodd-Frank gave the CFPB authority to oversee all non-bank mortgage companies; payday lenders, and private education lenders, regardless of size. Non-bank entities also include consumer reporting agencies, debt collectors, and money services companies.

CFPB supervision will include examinations and may require reporting. Examiners will review compliance with federal consumer financial laws for the entire life cycle of a product or service, including product development, marketing and sales practices, and management, and may interview personnel and observe operations and will be looking for the non-bank's internal ability to detect, prevent, and remedy violations that may harm consumers. As initial steps in supervision of non-banks, the CFPB recently published examination procedures for mortgage servicing and mortgage origination operations.

If a company is found to be in violation of federal consumer financial laws, the CFPB may take corrective actions, including strengthening of the company's procedures to ensure that violations do not recur and legal action.

Consumers Can File Online Complaints Against Credit Card And Mortgage Companies

The CFPB website now features interactive webpages where consumers may submit detailed complaints relating to credit cards and home mortgages. The mortgage and credit card complaint forms request the consumer to provide details of transactions and the result desired.

The credit card complaint form asks the consumer to select from a number of issues, including credit determination, APR, arbitration, balance transfer, billing, collection disputes, over the limit and other fees, privacy, and many others, implicating numerous consumer protection regulations including, the Truth In Lending Act, the Fair Credit Reporting Act, the Equal Credit Opportunity Act, and the Fair Credit Billing Act. The form also asks what steps the consumer has taken to try to resolve the issue and whether legal action has been filed. The mortgage complaint form also requests details on whether the issue involved a credit offer, the loan application process, underwriting, payment and costs, loan modification, collection, foreclosure, and/or discrimination.

The site states that the consumers' complaints will be forwarded to the business entity involved, and that the CFPB will keep the consumer updated as to the status of resolution.

CFPB Seeks Comment On Model Credit Card Agreement

The CFPB is seeking comment on a prototype credit card agreement developed and published as part of its "Know Before You Owe" initiative. The prototype is also being tested with 350,000 Pentagon Federal credit union cardholders.

While not mandatory, the prototype illustrates what the CFPB considers to be a compliant agreement that provides clear disclosures and "makes it easier for consumers to understand their credit cards." The prototype, said to be 80% shorter than the current industry average, has separate sections disclosing "Costs," (interest rates, fees, payments), "Changes" (to terms) and "Additional Information" (such as billing disputes and credit reporting information).

The CFPB has also formulated standard definitions for terms such as "prime rate," "balance transfer," "cash advances," and "minimum payment," available on the CFPB website and to be provided to the card holder in printed form by the card issuer.

Lawyers Chastised for Ignoring Adverse Authority on Appeal

BY MICHAEL WOLGIN

Judge Richard Posner of the Seventh Circuit Court of Appeals recently described the proper approach counsel should take in addressing authority that is adverse to his or her position on appeal. In *Gonzalez-Servin v. Ford Motor Co.*, Judge Posner addressed briefs by appellants' counsel in two separate cases appealing transfer on forum non conveniens grounds. Both cases derived from transfers in large ongoing multi-district litigations that had been affirmed by the Seventh Circuit.

Noble, but unfit for appellate advocacy

In one case, appellants' counsel ignored the Seventh Circuit's recent precedent in both the opening brief and reply, despite appellees' arguments based principally on the Seventh Circuit authority. In the other case, the relevant Seventh Circuit precedent was decided after the appellants' opening brief, but before the appellees' brief, which cited the authority heavily. Instead of responding to it, appellants' counsel largely ignored the Seventh Circuit precedent, and misconstrued the appellees' arguments on that issue. Judge Posner characterized the approaches taken by appellants' counsel as "unacceptable," comparing (with illustrations) their advocacy to an ostrich burying its head in the sand. Judge Posner explained, **[w]hen there is apparently dispositive precedent, an appellant may urge its overruling or distinguishing or reserve a challenge to it for a petition for certiorari but may not simply ignore it."** Judge Posner quipped, "[t]he ostrich is a noble animal, but not a proper model for an appellate advocate."

Arbitration Roundup

BY LANDON CLAYMAN

The U.S. Supreme Court's attention to arbitration matters has not abated this term. The Court has policed state court rulings, reversing two decisions that strayed from established arbitration doctrine, and issued an opinion that again displays this Court's robust interpretation of the Federal Arbitration Act. In *Marmet Health Care Center, Inc. v. Brown*, the Court chided the West Virginia Supreme Court for having characterized the Court's interpretation of the FAA as "tendentious" and "created from whole cloth," and reversed the state court's ruling that the FAA does not preempt West Virginia public policy against pre-dispute arbitration agreements that apply to claims of personal injury or wrongful death against nursing homes. Similarly, in *KPMG LLP v. Cocchi*, the Court reached down to an intermediate state appellate court in Florida to reverse a decision declining to compel arbitration because two of the four claims in the complaint were not arbitrable. Emphasizing that state courts, like federal ones, must enforce the FAA, **the Court reiterated that if a dispute presents both arbitrable and nonarbitrable claims, the FAA requires that the former claims be arbitrated, even if that results in piecemeal litigation**.

In January 2012, the Court reversed the Ninth Circuit's holding that the Credit Repair Organizations Act (CROA) precludes enforcement of an arbitration agreement in a lawsuit for violations of that Act. In *CompuCredit Corp. v. Greenwood*, consumer credit card holders filed a class action complaint alleging violations of CROA. CROA contains a disclosure provision requiring, before any contract is executed, that credit repair organizations give notice that consumers have "a right to sue" for violations of CROA. The act also provides that any waiver by a consumer of any protection or right afforded by CROA will be treated as void and unenforceable. The district court and the Ninth Circuit ruled that the "right to sue" notice entitles a consumer to bring an action in a court of law, and that the non-waiver provision prohibited the arbitration clause in the plaintiffs' credit card agreements from depriving the plaintiffs of the "right to sue" in court. The Court reversed, ordering that the arbitration agreement be enforced according to its terms. In the Court's view, the disclosure provision did not create a right to bring an action in a court of law. In addition, given the FAA's reflection of a liberal federal policy favoring arbitration, the Court concluded that CROA's disclosure requirement did not constitute a "congressional command" overriding the FAA's mandate that courts enforce arbitration agreements.

The America Invents Act Redux

First-Investor-to-File Considerations Commence Soon

BY DIANE DUHAIME

In our last issue we reported that the Leahy-Smith America Invents Act (the AIA) changes the United States patent system from a first-to-invent system to a first-inventor-to-file (FITF) system for determining who is entitled to qualify for a patent on an invention.

The FITF system will apply in general to patent applications for new claims filed **on or after March 16, 2013.** The AIA, however, includes a grace period that permits an inventor to file a patent application **up to one year** after the occurrence of certain public disclosures of the invention. **Commencing on March 16, 2012**, inventors will want to be aware of how they can possibly leverage the grace period with regard to their intellectual property protection.

The term "disclosure" is not defined in the AIA, so it is not yet known to whom a disclosure would need to be made, or what content must be included in the disclosure. Regardless, commentators seem to agree that if a disclosure includes content that would be considered "prior art," that disclosure will be sufficient to trigger the grace period protections described above.

Significantly, those same disclosures can also act as prior art against another's application that was filed first. "Prior art" basically means the claimed invention was patented, described in a printed publication, in public use, on sale, or otherwise available to the public before the effective filing date of the claimed invention. Therefore, by making a public disclosure of the invention, one can be permitted to seek patent protection *and* thwart another's earlier filed application so long as one's application is filed within the grace period.

Commencing on March 16, 2012, your company may wish to consider the implications of making a disclosure prior to the filing of a provisional or non-provisional patent application. It appears that the early filing of a provisional patent application would, however, provide more certainty for patent eligibility than relying on a disclosure; especially if the disclosure is not likely to qualify as prior art. Moreover, in many foreign countries, *any* public disclosure of the claimed invention, whether in the U.S. or elsewhere, may result in the loss of the right to seek a patent in those countries.

NLRB Issues Social Media Report 2.0

BY MICHAEL PETRIE

Since the advent of online social media, with just a few taps on a keyboard or smart phone, employees are now armed with a powerful voice that allows them to broadcast their gripe du jour. Whether a complaint is legitimate or frivolous, disparaging remarks posted on social media can easily reach customers, vendors, business partners, and sometimes mainstream media. Common solutions have included instituting strict social media policies that prohibit online bashing, and terminating the employment of vociferous employees.

Employees have found an ally in the National Labor Relations Board (the Board), which has taken a deep interest in social media issues because Section 7 of the National Labor Relations Act (the Act) provides all employees (not just unionized ones) with a right to engage in protected concerted activity, which includes criticizing employer policies, treatment of employees, wages, terms, and conditions of employment. In August 2011, the Board issued a report summarizing several of its decisions that arose at the intersection of employees' right to engage in concerted protected activity and the employer's interest in prohibiting employees from publicly bashing their employer and supervisors. **The Board warned then that employers with overly strict policies that chill employees' right to engage in protected activity, or who discipline employees for making workplace related complaints in social media, may find themselves in violation of the Act.**

On January 24, 2012, the Board issued a second report summarizing fourteen additional cases.

Although the cases are highly fact specific, a familiar theme emerges: Employee is criticized or experiences some adverse decision and takes to social media to vent his or her frustration, followed by swift disciplinary action, often termination of employment. The Board has distilled these cases into two pieces of advice: (1) Employer policies may legitimately be aimed at limiting derogatory public statements, but should not be so sweeping that they prohibit protected concerted activity; and (2) An employee's complaints made on social media will not be protected, and thus may be the subject of discipline, if they are mere personal gripes that do not relate to group activity about terms and conditions of employment.

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