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EXPECT**FOCUS**® is a quarterly review of developments in the insurance and financial services industry, provided on a complimentary basis to clients and friends of Jorden Burt LLP.

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INTHE**SPOTLIGHT**

Jorden Burt Obtains Victory in Massive Nationwide Class Action

BY MICHAEL KENTOFF

On October 12, 2009, a Jorden Burt LLP defense team obtained a decisive victory for Allianz Life Insurance Company of North America in *Mooney v. Allianz Life Insurance Company*, a nationwide class action case pending in United States District Court in Minneapolis, Minnesota. Linda Mooney filed a Complaint in February 2006 on behalf of certain Allianz annuity policyholders under the Minnesota Prevention of Consumer Fraud Act. After a three-week trial before Judge Ann Montgomery, a jury found that Allianz's conduct had not caused loss or damage to any class member.

The case initially involved allegations of misrepresentations in some marketing materials relating to certain annuity products purchased between February 9, 2000 and May 10, 2007. The case expanded to other sales policies and practices, and grew to be one of the largest class actions against an insurance company, implicating over 400,000 policies.

Our partner, Jim Jorden, lead counsel for the Jorden Burt trial team, was recently quoted as pointing out that the evidence demonstrated that "people who read the [sales materials] were not misled" and plaintiffs "failed to prove that there was evidence of any shortcomings regarding the substance and disclosure in the materials." He stated that: "We have always believed that Allianz Life has treated its annuity owners properly, that its sales practices and sales materials were appropriate and that its annuities have provided excellent value to its customers. We are pleased that the jury vindicated Allianz Life's position on all of these issues."

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Class Action Dismissed For Lack Of Subject Matter Jurisdiction

BY TODD FULLER

The U.S. District Court for the Southern District of New York recently dismissed a class action attempting to assert claims for breach of fiduciary duties under ERISA in connection with a group annuity contract endorsed by the New York State United Teachers (NYSUT) and used to fund School District 403(b) retirement plans throughout the State of New York. In *Montoya v. ING Life Insurance and Annuity* Co., *NYSUT, et al.*, two employees of the Long Beach City School District brought a putative class action against NYSUT, NYSUT Trust, ING Life Insurance and Annuity (ILIAC), and ten individual Trustees seeking to represent a class of all union members who chose to use ILIAC's Opportunity Plus tax deferred annuity under their employer's 403(b) retirement plan. The complaint alleged that ILIAC's group annuity contract was a separate ERISA plan, that defendants were ERISA fiduciaries, and defendants breached their fiduciary duties by paying and accepting endorsement fees and accepting "revenue sharing" payments from mutual funds. The complaint sought damages for various injuries allegedly suffered by the plans, including disgorgement of all endorsement fees received by NYSUT Trust, and disgorgement of all revenue sharing payments received by ILIAC. Jurisdiction was based entirely on ERISA.

ILIAC and the NYSUT defendants moved to dismiss for lack of subject matter jurisdiction, arguing that plaintiffs' 403(b) retirement plan was a "governmental plan" established by the School District and exempt from ERISA. The court agreed and dismissed the case in its entirety. The court held that, given the School District's involvement and funding of the 403(b) plan, it was clear that the School District had established a 403(b) retirement plan which was a "governmental plan" exempt from ERISA. The court rejected plaintiffs' contention that an ERISA "safe harbor" provision could be used to show that the School District did not establish or maintain the plan, explaining that the regulation applies only to private charitable organizations and not to governmental plans which are already exempt from ERISA. The Court also noted that the complaint failed because under Section 403(b) only an "employer" like the School District (and not a union) may establish a tax exempt 403(b) plan. The court observed that adopting plaintiffs' position "would call into question the validity of the tax benefits plaintiffs have received over the years by participating in [Opportunity Plus]." Jorden Burt successfully represented ILIAC in the case.

Life Settlement Activities Invite Regulatory Scrutiny

BY ANN FURMAN

The SEC has announced that it is paying special attention to the life settlement business, which represented a $16 billion industry in 2008.

Chairman Mary Schapiro has established a *Life Settlements Task Force*, composed of senior officials throughout the SEC, to examine emerging issues in the life settlements market and to advise the SEC whether market practices and regulatory oversight can be improved.

The Task Force will study securitization of life settlements and whether securities offerings that purport to rely on exemptions from registration under the federal securities laws are doing so properly. The Task Force also will research life settlement sales practices, fees, and disclosure, both in terms of the sale of existing life insurance policies by contract owners and the sale of interests in life settlement pools to investors.

SEC to study life settlements

In September 24, 2009, testimony before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the House Committee on Financial Services, Paula Dubberly, Associate Director of the Division of Corporation Finance, testified that "the SEC has taken the position that life settlements are securities, and, therefore, are subject to the requirements of the federal securities laws." Ms. Dubberly acknowledged, however, that courts have not taken a unanimous view on the securities status of life settlements.

The SEC Life Settlement Task Force intends to work closely with FINRA, NASAA, and the NAIC to coordinate regulatory efforts and analyze whether gaps in oversight exist. For its part, FINRA issued Regulatory Notice 09-42 in July, 2009 to remind FINRA members of their obligations with variable life settlement activities.

Federal Court Dismisses M&E Charge Claims in Putative Nationwide Class Action

BY SHAUNDA PATTERSON-STRACHAN

On September 22, 2009, in *Nichols v. John Hancock Life Insurance Company*, a federal district court judge in the Northern District of Alabama issued an order granting a motion to dismiss the plaintiff's complaint, which had asserted a single count for breach of contract. The plaintiff was the owner of a variable annuity contract issued to him as beneficiary of his mother's contract upon her death, pursuant to his exercise of the contract's "stretch" option instead of accepting the cash death benefit. The gravamen of his complaint was that Hancock improperly charged mortality and expense fees on the separate account funds in his variable annuity because no death benefit was provided under his "stretched" contract.

Hancock's motion to dismiss for failure to state a claim – which came on the heels of its removal of the lawsuit to the federal district court from a state court in Alabama – set forth a number of grounds for dismissal, including Securities Litigation Uniform Standards Act preclusion, and preemption based on the National Securities Market Improvement Act of 1996. But on the strength of the briefing alone, Judge L. Scott Coogler found sufficient bases for dismissal of the action in Hancock's traditional breach of contract arguments. Specifically, based on the plain language of the contract, the judge determined "it is evident that there are no provisions that a mortality charge or any fee would be collected in exchange for a death benefit. Nothing in the Contract ties any fee solely to the guarantee of a death benefit." Accordingly, the plaintiff failed to allege facts establishing nonperformance amounting to a breach of the annuity contract.

Jorden Burt LLP served as outside counsel for John Hancock in this litigation.

U.S. Supreme Court to Review Arbitrability of Class Claims

BY AILEEN WARREN

On June 15, 2009, the U.S. Supreme Court granted certiorari in *Stolt-Nielsen S.A. v. AnimalFeeds International* to consider whether the Federal Arbitration Act (FAA) permits class arbitration to be imposed on parties whose arbitration clauses are silent regarding class arbitration. The issue presented is the same that the Court declined to reach in *Green Tree Financial Corp. v. Bazzle* (2003).

The district court in *Stolt-Nielsen* vacated an arbitration award which had interpreted a maritime contract's arbitration clause to permit class claims, holding that the award was in "manifest disregard of the law." The Second Circuit disagreed and reversed the decision, reasoning that *Bazzle* held that when parties agree to arbitrate, the question of whether the agreement allows class arbitration is a contract interpretation issue to be assessed by the arbitrators under the relevant substantive law. The Second Circuit explained that petitioners had not cited any controlling legal authority prohibiting class arbitration when the arbitration clause was silent on the issue.

Silence does not prohibit class arbitration

Petitioners argue that the Second Circuit's interpretation of *Bazzle* conflicts with other circuits' opinions which prohibit class arbitration unless expressly provided for in the arbitration agreement. Respondents counter that petitioners have not demonstrated any of the limited bases for vacating an arbitration award under the FAA. These bases, according to respondents, are limited to corruption, fraud, partiality, or a decision in excess of the arbitrator's powers. Respondents also argue that petitioners had agreed in writing that this was an issue for the arbitrators, and that there cannot be "manifest disregard of the law" where the parties agreed the issue was one of first impression under maritime law. The respondents' brief was filed on October 20, 2009. Oral arguments are scheduled for Wednesday, December 9, 2009.

Court Reaffirms Dismissal of Putative 412(i) Class Action

BY TODD FULLER

Without specific facts, fraud claims go nowhere

Earlier this year, in *Berry v. Indianapolis Life Insurance Company, et al.*, the U.S. District Court for the Northern District of Texas granted Indianapolis Life's motion to dismiss a putative nationwide class action against several insurers relating to the design, marketing and sale of life insurance policies purportedly used to fund Section 412(i) defined benefit pension plans. The Court dismissed plaintiffs' fraud-based claims for failure to plead with specificity, and noted that the complaint failed to demonstrate why alleged representations regarding the validity of plaintiffs' 412(i) plans made several years prior to IRS guidance issued in 2004 were false when made. The Court also held that any predictions by an alleged Indianapolis Life agent regarding how the IRS would treat 412(i) plans in the future was "either an unactionable opinion or was unjustifiably relied upon."

The Court allowed plaintiffs to file an amended complaint to overcome the pleading deficiencies identified in its opinion, but on July 16, 2009, the Court reaffirmed its earlier ruling and dismissed the plaintiffs' fraud-based claims with prejudice. After considering plaintiffs' amended allegations, the Court concluded that, notwithstanding the complaint's addition of IRS pronouncements made prior to 2001, plaintiffs still could not identify any definitive guidance by the IRS "to explain why the alleged representations by Indianapolis Life's agents were false when made in 2001 and 2002." The Court also held that alleged representations regarding the tax consequences and validity of plaintiffs' plans were merely predictions or opinions as to how the IRS would treat plaintiffs' plans in the future which, as a matter of law, could not form the basis of a fraud claim. Jorden Burt represented Indianapolis Life in this case.

MDL Panel Consolidates 412(i) and 419 Plan Litigation

BY TODD FULLER

In re Indianapolis Life Ins. Co. Internal Revenue Service § 412(i) Plans Life Insurance Marketing Litig., (MDL No. 1983), was originally created to centralize claims relating to the design, marketing, and sale of specially designed life insurance policies used to fund defined benefit pension plans under § 412(i) of the Internal Revenue Code. Indianapolis Life recently requested that the proceeding be expanded to include cases, such as *Paul v. Aviva Life and Annuity Company* (the successor to Indianapolis Life), which assert claims relating to employee benefit plans formed under § 419 of the tax code because the core factual allegations asserted in these actions are nearly identical, with each asserting a variety of fraud-based claims relating to the design, marketing, and sale of certain Indianapolis Life insurance policies used by the plaintiffs to fund employee benefit plans for their small businesses.

On August 10, 2009, the MDL Panel issued an order transferring *Paul* to MDL No. 1983 for centralized pretrial proceedings. The MDL Panel recognized the "common questions of fact" between the actions and noted that "[t]he previously centralized MDL No. 1983 actions involve the funding of small business defined benefit pension plans with Indianapolis Life insurance policies which were represented to be in compliance with U.S. Internal Revenue Service (I.R.S.) § 412(i). *Paul* involves similar allegations involving Indianapolis Life policies used to fund small business I.R.S. § 419 welfare benefit plans." The MDL Panel noted that although "*Paul* may involve some unique questions of fact relating to § 419 plans, the transferee judge can establish a separate track, if necessary, to address any unique factual and legal issues which may arise." The MDL Panel also renamed MDL No. 1983 "*In re Indianapolis Life Ins. Co. I.R.S. § 412(i) and § 419 Plans Life Insurance Marketing Litig.*" to reflect the inclusion of cases asserting claims relating to § 419 welfare benefit plans. Jorden Burt represents Indianapolis Life in these cases.

Courts Take Divergent Paths in Annuity Certification Decisions

BY DAWN WILLIAMS

Two federal courts recently took different approaches in deciding whether classes of fixed indexed annuity owners should be certified.

In *Duchardt v. Midland Nat'l Life Ins. Co.*, the U.S. District Court for the District of Iowa determined that certification was not appropriate in an action challenging the company's interest crediting mechanism. The named plaintiff purported to represent owners of eighteen different types of annuities, some of which had differing language in the interest crediting definition. The court first held that the proposed subclass–which included all individuals whose account values were lower because of the interest credited–was not ascertainable without individualized inquiry. The court then found that the named plaintiff's claims were not typical of the class because he sought to represent individuals who have different contract language, and because the contract law of the class members' states of domicile (47 states in all) varied in how to interpret ambiguous terms. Duchardt was then found to be inadequate because his interests might be in conflict with class members who benefitted from Midland's crediting method.

Courts in different directions in annuity certification

Conversely, the Ninth Circuit reversed a decision denying certification against the same insurer in *Yokoyama v. Midland Nat'l Life Ins. Co.*, in which the plaintiff claimed that the company marketed and sold annuities to seniors living in Hawaii in violation of that state's Deceptive Practices Act. The court found that Hawaii law required no individualized showing of reliance, and thus "there is no reason to look at the circumstances of each individual purchase in this case … and the fact-finder need only determine whether [Midland's] brochures were capable of misleading a reasonable consumer." The court noted that there could be individualized damages determinations (because each person's damages would depend upon their financial circumstances and objectives and the particular status of each person's annuity), but held that such individualized damage determinations would not defeat certification.

Class Certification Denied In ERISA Breach Of Fiduciary Duty Case

BY ROBIN SANDERS

On June 15, 2009, the U.S. District Court for the Middle District of Louisiana denied class certification in an action brought pursuant to ERISA against Pan-American Life Insurance Company related to non-discretionary administrative services it provided to an employer-sponsored 401(k) defined contribution plan. The plaintiffs in *Turner v. Talbert*, several 401(k) plan participants, had brought suit against Pan-American alleging that it conducted itself as an ERISA fiduciary and breached its fiduciary duty to the 401(k) plan.

In denying their motion for class certification, the court held that the plaintiffs failed to satisfy the predominance and superiority requirements of Federal Rule of Civil Procedure 23(b)(3). The court held that, based on plaintiffs' class definition–which sought relief on behalf of all plan participants who incurred losses as a result of Pan-American's alleged breach of fiduciary duty–determining class membership, as well as the fact of injury and extent of damages, would require an individualized review of each plan participant's past and hypothetical future investment allocations. Since the case had the potential to degenerate into multiple individual lawsuits, the court found that common issues of fact and law did not predominate over the individual questions.

Plaintiffs subsequently filed a motion for reconsideration in the district court and a Rule 23(f) petition for appellate review with the U.S. Court of Appeals for the Fifth Circuit, both of which were denied. The case is now proceeding on the merits of the plaintiffs' individual claims. Jorden Burt acted as counsel for Pan-American in defending against plaintiffs' attempts at class certification.

Court Dismisses Derivative Suit Against Citigroup's Directors and Officers

BY JIM GOODFELLOW

In *Louisiana Municipal Police Employees Retirement System v. Pandit, et al.*, the District Court for the Southern District of New York dismissed the plaintiffs' claim because demand was not futile for the purposes of litigating their shareholder derivative action.

The plaintiffs alleged that the defendants, as a result of Citigroup's involvement in the auction-rate securities market and alleged manipulation of that market, caused Citigroup to incur billions of dollars in fines and losses. The plaintiffs argued that demand was futile because of the substantial likelihood that the directors would face personal liability in connection with the subject matter of the plaintiffs' lawsuit.

The defendants moved to dismiss the complaint pursuant to Federal Rule of Civil Procedure 23.1, which requires that plaintiffs plead with particularity any effort made to obtain the desired action (demand) or the reasons for not making such effort (typically "demand futility").

In its decision, the court applied a "red flags" test, in analyzing the plaintiffs' demand futility argument. It found that the test was not satisfied, as plaintiffs failed to plead with sufficient particularity that the defendant directors and officers ignored "red flags" that they would face a substantial likelihood of liability for the deterioration of the company's financial position. The court held that the so-called "red flags" alleged were merely indications of a deteriorating economic picture, and not of any likelihood of liability on the part of the directors and officers.

Unintentional Business Error No Accident

BY JACOB HATHORN

The Indiana Supreme Court has held in *Tri-Etch, Inc. v. Cincinnati Insurance Company* that a security company's negligent performance of its alarm-monitoring duties was no "accident" for purposes of determining whether coverage existed under the company's CGL and umbrella insurance policies.

Among the security services that Tri-Etch provided to a liquor store was daily monitoring to ensure activation of the store's night alarm system when the store closed at midnight. One night, Tri-Etch noted a failure by the store to activate its alarm, but did not alert the store's manager until shortly after 3:00 a.m. The alarm was never activated that night because the store clerk on duty, Michael Young, was abducted by a robber, tied to a nearby tree in a local park, and severely beaten. Young was not discovered until 6:00 a.m., and died of his injuries later that day. Young's Estate brought a wrongful death action against Tri-Etch, alleging that Young would have been discovered earlier and would have survived had Tri-Etch performed its duty to notify the store manager that the alarm had not been set within thirty minutes of the store's closing time. A jury awarded $2.5 million to the Estate.

Late call was a fatal mistake

Tri-Etch looked to its insurers to satisfy the judgment. It had a $1 million CGL policy with Scottsdale Insurance Company, as well as a second $1 million CGL policy and $2 million umbrella policy, both issued by Cincinnati Insurance Company. After Scottsdale tendered its $1 million policy limit, Tri-Etch settled with the Estate by assigning its claims against Cincinnati to the Estate. The Estate then filed an action against Cincinnati to recover the unpaid $1.5 million balance of the wrongful death judgment. Cincinnati prevailed on summary judgment, but suffered a reversal when the Court of Appeals, noting that Cincinnati's CGL and umbrella policies both insured against liability for bodily injury caused by an "occurrence," which both policies defined as an "accident," ruled that the Estate's loss arose from an "occurrence" because it was caused by Tri-Etch's unintentional oversight in failing to make the 12:30 a.m. call.

The Indiana Supreme Court reversed, concluding that Tri-Etch's failure to timely contact the store owner was more accurately an "error or omission" than an "accident." The Court refused to construe "accident" so broadly as to encompass claims based on negligent performance of commercial or professional services, which would ordinarily be covered, if at all, under an E&O or malpractice policy. While the exhausted Scottsdale policy had included errors and omissions coverage, the Cincinnati CGL and umbrella policies both expressly excluded such claims arising from Tri-Etch's alarm-monitoring services. Consequently, Cincinnati never owed a duty to indemnify Tri-Etch for the remaining $1.5 million.

"Insured Versus Insured" Exclusion Applies in Dispute

BY DAN CRISP

In *Biltmore Assoc., LLC v. Twin City Fire Ins. Co.*, the Ninth Circuit Court of Appeals upheld the applicability of the "insured vs. insured" exclusion under certain D&O policies, where the insured company filed claims as a debtor in possession against former directors and officers of the company. Visitalk.com, Inc., which had filed for Chapter 11 bankruptcy protection, asserted claims as debtor in possession against four of its former directors and officers for breach of fiduciary duties. Visitalk's professional liability insurers denied coverage, citing the "insured versus insured" exclusion. The exclusion at issue bars coverage for claims against the directors and officers "brought or maintained by or on behalf of an Insured in any capacity."

Directors and officers should be cautioned

Following the denial of coverage, Visitalk assigned its claims to the creditors' trustee, then settled with the directors and officers for a confession of judgment and an assignment of claims, and the trust then filed suit against the insurer on the basis of these claims.

The district court dismissed the case for failure to state a claim. On appeal, the Ninth Circuit affirmed the dismissal, but on different grounds, instead basing its affirmance on the applicability of the exclusion. The court cited the purpose of the exclusion generally of curbing potential collusion and other moral hazard arising from the relationship between insureds. The court found the exclusion applicable because a post-bankruptcy debtor in possession acts in the same capacity as the pre-bankruptcy debtor.

While directors and officers should certainly be cautioned, the practical effect of the decision may be a dampening of bankruptcy adversary litigation, with high-policy-limit coverage off the table in many circumstances.

"Claims-Made" Strictly Construed By Kentucky Appellate Court

BY JONATHAN STERLING

In *AIG Domestic Claims v. Tussey*, the Court of Appeals of Kentucky adopted the majority rule that failure to notify an insurer of a claim under a claims-made policy within the policy period will defeat coverage. The case concerned two errors and omissions policies issued by National Union Fire Insurance Company (a subsidiary of AIG) to a county board of education. The policy periods were July 1, 2005 to July 1, 2006, and July 1, 2006 to July 1, 2007. In February 2006, a teacher commenced a gender discrimination case against the board. However, the board did not make a claim under the first National Union policy until April 2007. A claim was made under the second policy in January 2008. National Union denied both claims, asserting that the policies were "claims-made-and-reported" policies which required claims to be reported within the policy period to be covered.

The board and the teacher brought suit against National Union and AIG, asserting that the policies covered the claims. The trial court granted summary judgment to the board and the teacher on this issue, denying AIG's and National Union's summary judgment motions. AIG and National Union appealed and the Court of Appeals reversed the trial court. The Court of Appeals found the claims-made provision to be unambiguous and held that a claim would be excluded if made outside the policy period, even if the policy was continuously renewed. The court pointed to the fact that claims-made policies are less expensive than occurrence-based policies, which can create long "tails" of potential future liability. To find coverage, the court said to give the insured a benefit for which they did not bargain.

Federal Reinsurance Reform Headlines Legislative Activity

BY KAREN BENSON

Action by the U.S. House of Representatives highlights our latest update on legislative and regulatory activity of interest to the reinsurance industry.

Federal Reinsurance: The U.S. House of Representatives unanimously adopted *The Nonadmitted and Reinsurance Reform Act of 2009* (H.R. 2571). The principal provisions of the bill: (1) regulate premium taxes for nonadmitted insurance; (2) provide that the placement of nonadmitted insurance shall be subject to regulation solely by the insured's home state; (3) limit the ability of a state to establish eligibility requirements for U.S.-domiciled nonadmitted insurers that vary from the Non-Admitted Insurance Model Act; (4) require a GAO study of the nonadmitted insurance market; (5) regulate the extent to which a state may not recognize credit for reinsurance for an insurer's ceded risk; (6) partially pre-empt the extraterritorial application of the law of a state to a ceding insurer not domiciled in that state; and (7) provide that in most circumstances a state that is the domicile of a reinsurer shall be solely responsible for regulating its financial solvency. The bill was received in the Senate and referred to the Committee on Banking, Housing, and Urban Affairs on September 10, 2009.

Other reinsurance legislation (H.R. 3424) introduced in the U.S. House of Representatives seeks to amend the Internal Revenue Code of 1986 to disallow the deduction for excess non-taxed reinsurance premiums paid to affiliates with respect to U.S. risks.

Federal Catastrophe: *The Commission on Catastrophic Disaster Risk and Insurance Act of 2009* (S. 1487) proposes to establish a bipartisan commission on catastrophic disaster risk and insurance. The *Policyholder Disaster Protection Act of 2009* (S.1486) proposes to amend the Internal Revenue Code of 1986 to allow property and casualty insurance companies to create disaster protection funds for the payment of policyholders' claims arising from future catastrophic events.

Many hands working on reinsurance reform

State Reinsurance: The Oregon Division of Insurance (DOI) adopted Oregon temporary administrative rule (OAR) 836-012-0331 concerning the treatment of reinsurance reserve credits or assets under agreements prior to November 9, 1995. The temporary rule replaces OAR 836-012-0330, which, according to the DOI, was apparently repealed in error. The repeal of that rule had removed the prohibition on an insurer reporting reserve credits or assets established with respect to existing reinsurance agreements entered into prior to the effective date of the Life and Health Reinsurance Agreements Model Regulation (OAR 836-012-0300 to 836-012-0330). According to the DOI, the repeal violated the Reinsurance Ceded accreditation standard, Part A, 10(m). In order to remain accredited, the DOI was required to adopt the temporary rule. The temporary rule provides that any reserve credits or assets established with respect to existing reinsurance agreements entered into prior to November 9, 1995, that would not be entitled to recognition under the provisions of OAR 836-012-0300 to 836-012-0330 must be reduced to zero for purposes of the insurer's annual statement filing. The temporary rule is effective July 9, 2009, through December 24, 2009.

NAIC Proposes Change to Accounting For Reinsurance In Certain Run-Off Situations

BY ROLLIE GOSS

On June 13, 2009, the NAIC exposed for comment Issue Paper No. 137, which proposed changes to Statement of Statutory Accounting Principle No. 62–Property and Casualty Reinsurance (SSAP No. 62). The proposed change provides an exception to accounting principles for retroactive reinsurance agreements for reinsurance and/or retrocession agreements that meet the criteria of property and casualty run-off agreements described in the issue paper. This proposal has progressed to the stage that at the Fall meetings of the NAIC, a proposed amendment to SSAP No. 62 was exposed for comment. The comment period expired October 28, 2009. A public hearing was to be held on the proposal with interested parties having the opportunity to submit written comments and/or seek to speak at the hearing. For more information, go to the web pages of the NAIC's Statutory Accounting Principles Working Group (*www.naic.org*). Copies of the exposure items also are available on Jorden Burt's reinsurance/arbitration blog, Reinsurance Focus (*www.ReinsuranceFocus.com*).

Court Says Unauthorized Insurer May Bring Suit Against Reinsurers In Florida

BY ANTHONY CICCHETTI

Section 626.903 of the Florida statutes provides that "no unauthorized insurer shall institute, file, or maintain … any suit, action, or proceeding in this state to enforce any right, claim, or demand arising out of any insurance transaction in this state." In *Advantage General Insurance Co., v. KILN/QBE International*, the plaintiff ceding company's suit against its reinsurers seeking payments under a reinsurance contract was dismissed by the trial court because the ceding company was not an authorized insurer in Florida. The District Court of Appeal reversed, concluding that the lawsuit did not "arise out of an unauthorized insurance transaction" by the plaintiff.

Citing the protection of Florida's insureds as the "self-proclaimed purpose" of the unauthorized insurer laws, the appellate court reasoned that, in the context of a reinsurance transaction, the ceding company was the insured. Thus, the lawsuit at issue was brought by the plaintiff in its capacity as an insured and arose out of the reinsurance contract, not the insurance contract with the underlying insured. Although the court acknowledged that the ceding company would be barred from bringing an action in a Florida court against its underlying insured, the court concluded that the ceding company was not barred from suing its reinsurers. The court's "arising out of" analysis did not address that the underlying risk, which apparently was assumed pursuant to an unauthorized transaction, was also the subject of the reinsurance contract at issue.

Not in FL? Court says insurer can still bring suit

NAIC Revamps Proposed Reinsurance Regulatory Modernization Act

BY JOHN PITBLADO

We previously reported on federal legislation proposed by the NAIC titled the Reinsurance Regulatory Modernization Act of 2009 (RRMA). Broadly, the bill would establish a Reinsurance Supervision Review Board, which would oversee the regulation of two new classes of reinsurers in the U.S. –"national reinsurers" (licensed and domiciled in a U.S. state) and "port of entry" (POE) reinsurers (non-U.S. reinsurers certified in a U.S. port of entry state). The RRMA also would establish collateral requirements for reinsurance ceded to these reinsurers, based on financial strength ratings assigned to them by their respective U.S. supervising jurisdiction.

The NAIC exposed its first draft of the RRMA in March 2009, and comments submitted by various industry participants reflected a number of concerns with the proposed legislation, including constitutional questions about the apparent delegation to the NAIC of regulatory authority under the proposed law. After seeking legal advice on constitutional questions, the NAIC exposed a revised draft in late July 2009. The comments on the revised draft reveal that the constitutional concerns have diminished, although many of the commenters continue to express other concerns, particularly with respect to the collateral requirements.

Generally, representatives of the interests of domestic cedents continue to disagree with the need for reform of the current collateral requirements. They also reiterated a concern that the RRMA unfairly alters the balance in favor of foreign reinsurers who are not licensed and who do not maintain assets in the United States. Voices from overseas, however, strike a more positive note than their domestic counterparts, and generally reflect satisfaction that at least some of their initial concerns were addressed in the revised draft. Comments on behalf of domestic reinsurers are more ambivalent in tone, expressing a combination of support for comprehensive reinsurance regulatory reform, but concern that the revised draft still falls short of meaningful reform.

The NAIC's Reinsurance Task Force adopted the revised RRMA on September 15, 2009.

Life and Health

NAIC Suitability Model Regulation

BY ANN FURMAN

State insurance regulators made a course correction in their protracted consideration of the *Suitability in Annuity Transactions Model Regulation*. Prior to the NAIC fall meeting in late September, a sub-group of the Suitability Working Group had prepared and recommended a new revised draft suitability model regulation (dated September 4, 2009), which is modeled after FINRA Rule 2821, the suitability rule governing the sale of deferred variable annuities. The September 4 draft is annotated with parallel FINRA rule citations.

Since 2008, the Suitability Working Group had been considering another version of the model regulation. At its September 21, 2009 meeting, however, the working group voted to discontinue work on that version and move forward instead with the September 4 exposure draft. Among other things, the September 4 exposure draft:

- Holds an insurer, as well as a producer, responsible for the suitability of each sale;
- Requires an insurer to have a system for review, but not to review every sale; and
- Requires an insurer to adopt reasonable procedures for training, periodic review, inspection and the like.

Stronger enforcement might achieve the same goal

Meanwhile, industry trade groups and interested parties have voiced concern about revising a suitability model that the NAIC adopted in 2006 and some 46 states have either adopted or have followed with similar or related suitability standards. Some suggest that stronger enforcement of the current model would achieve the same goal as a new suitability model and that modeling the NAIC suitability regulation after FINRA Rule 2821 is ill-fitting. Rule 2821 applies to distributors, not to manufacturers of insurance products, and some securities concepts do not lend themselves to direct application to insurers. For example, in adopting securities concepts, the September 4 exposure draft does not address the sale of fixed annuities that do not have an investment component.

Several trade groups collaborated to craft a model bulletin to accompany the existing suitability model. The Suitability Working Group determined not to pursue the model bulletin.

In a comment letter dated October 15, 2009, five industry trade groups encouraged further consideration of the Model Bulletin as a complement to any final suitability model regulation.

Intellectual Property & Technology

Privacy Breaches and Class Action Lawsuits Against Financial Services Companies

BY DIANE DUHAIME & DAN CRISP

Plaintiffs have filed class action lawsuits against financial services companies on the grounds that the company failed to comply with the terms of its own privacy policy. One such class action case was filed in May, 2007 against TD AMERITRADE, Inc. (TD AMERITRADE). A TD AMERITRADE customer had received penny stock spam at two e-mail addresses linked to his TD AMERITRADE brokerage account, one of which was set up to test for a privacy breach of this account. In September, 2007, TD AMERITRADE announced that someone had hacked into a TD AMERITRADE database and stole the personally identifiable information of over 6 million current and former customers. The breach was linked only to the sending of penny stock spam to customers, not to any actual identity theft.

The parties initially agreed upon a proposed settlement of the class action lawsuit. The proposed terms included: (1) nearly $1.9 million in legal fees to the plaintiffs' attorneys; (2) one year of anti-spam software to the victims; and (3) TD AMERITRADE to take certain security measures, including hiring an individual to test TD AMERITRADE's security systems and retaining a security expert to test for evidence of identity theft. While preliminarily approving the proposed settlement, the court subsequently rejected it because, among other things, it viewed the terms as benefitting the plaintiffs' attorneys and TD AMERITRADE more than the class members.

Mutual Funds and Investment Adviser

SEC and FINRA Issue Joint Alert on Leveraged and Inverse ETFs

BY RICHARD CHOI

Prompted by concerns that buy-and-hold investors may not understand Leveraged and Inverse Exchange-Traded Funds (ETFs), the SEC and FINRA have jointly issued an alert warning investors that the long-term performance of these ETFs can differ significantly from their stated daily performance objectives. The regulators' concerns are underscored by putative class-action lawsuits that have been filed involving these types of ETFs.

The alert explains that Leveraged ETFs seek to deliver multiples of the performance of the index or benchmark they track, Inverse ETFs seek to deliver the opposite of the performance of the index or benchmark they track, and Leveraged Inverse ETFs seek to deliver a multiple of the inverse performance of an underlying index. The alert also explains that these ETFs seek to achieve their investment objectives through the use of derivative instruments, such as swaps and futures contracts.

The alert notes that most Leveraged and Inverse ETFs "reset" on a daily basis, meaning they are designed to achieve their stated objectives on a daily basis. As a result, their performance over longer periods of times can differ significantly from the performance (or inverse performance) of the index or benchmark they track during the same periods. The alert provides examples of how this difference can be magnified in volatile markets. The examples show that even if these ETFs perform exactly as they are designed to do, their long-term performance could be dramatically worse than the performance of the index or benchmark they track.

The alert urges investors to understand these products before investing in them and emphasizes the importance of reading the prospectus. It also urges investors to consider a number of factors before investing in these ETFs, including the techniques the ETFs use to achieve its stated objectives, the effect of holding ETFs longer than one trading day, and the risks, costs, and tax consequences associated with investing in ETFs.

Insurance Regulatory

Rule 151A Effective Date in Question

BY GARY COHEN

Efforts are being made to have the SEC defer the January 12, 2011 effective date for Rule 151A. The industry is caught between a rock and a hard place. On one hand, it's not clear that Rule 151A will ever become effective: the industry is fighting the Rule in the courts and Congress. (See *Expect Focus*, Vol. III, Summer 2009) On the other hand, companies need to begin the SEC registration process to be ready by the effective date. Companies do not want to begin that long, arduous and costly process unless Rule 151A is a done deal.

OM Financial Life Insurance Company (OM) has asked the U.S. Court of Appeals for the D.C. Circuit to stay the Rule until two years after the SEC has reissued, revised or withdrawn it.

The court has recently ordered further briefing by OM and the SEC on OM's motion. Reissuing or revising the Rule is likely to require the SEC to conduct a study of the Rule's impact on efficiency, competition and capital formation, including state insurance regulation. Furthermore, Senator Ben Nelson (D-NE) has asked SEC Chairman Mary Schapiro to push off the effective date in order that the SEC, state regulators and the industry can meet to explore the potential for compromise.

Prior to the court's recent briefing orders, the SEC has filed a response to OM's motions opposing any stay of Rule 151A and stating that because it was "unclear at this juncture" what action it will take on remand, OM's request was "premature and unwarranted." The SEC also asserted that there was no basis for OM's assumption that the SEC would refuse to extend the Rule's effective date if it were to reissue the rule.

In September, the SEC staff met with insurance companies in Washington, D.C. In spite of an expectation that the SEC would address the potential for compromise, the SEC had not determined what direction it would take, there was little to discuss.

SEC Scrubs Rules of References to Credit Ratings

BY ED ZAHAREWICZ

The SEC has adopted amendments to certain rules to remove references to credit ratings issued by nationally recognized statistical rating organizations. The amendments, which go into effect on November 12, 2009, are designed to address concerns that references to NRSRO ratings in SEC rules may have contributed to an undue reliance on those ratings by market participants. With regard to investment companies, the amendments affect changes to Rules 5b-3 and 10f-3 under the Investment Company Act. The SEC, however, deferred action and reopened the comment period on other proposed amendments to remove NRSRO ratings from existing rules, including Rule 2a-7 which governs money market funds.

Under Rule 5b-3, a "refund security" is a debt security the principal and interest of which are to be paid by U.S. government securities that have been escrowed and pledged for the payment of the debt security. Rule 5b-3 permits a mutual fund to treat the acquisition of a refunded security as an acquisition of the escrowed securities for diversification purposes, if certain conditions are met. As amended, the rule will no longer allow such treatment for a refunded security that has received a debt rating in the highest category from an NRSRO unless the an independent accountant has certified to the escrow agent that the escrowed securities will satisfy all scheduled payments on the refunded security.

Rule 10f-3 provides an exemption from the provisions of Section 10(f) of the Investment Company Act for purchases of certain securities, including eligible municipal securities, if certain conditions are met. Section 10(f) prohibits a registered fund from knowingly purchasing securities in an underwriting in which an affiliate is participating. The amended rule revises the definition of "eligible municipal security," which the current rule defines with references to NRSRO ratings, to mean securities that "are sufficiently liquid that they can be sold at or near their carrying value within a reasonable time" and are subject to either "no greater than moderate credit risk" or, for certain "less seasoned" securities, "a minimal or low amount of credit risk."

SEC Proposes Restrictions on Adviser Pay-to-Play Practices

BY KAREN BENSON

The SEC has proposed rulemaking aimed at addressing "pay-to-play" practices by investment advisers soliciting advisory business from government entities, including public pension plans. According to the SEC, pay-to-play practices distort the process by which advisers are selected, can harm clients who may receive inferior advisory services and pay higher fees, and are inconsistent with the high standards of ethical conduct required of advisers under the Investment Advisers Act.

Modeled on rules adopted by the Municipal Securities Rulemaking Board to address pay-to-play practices in the municipal securities market, proposed Rule 206(4)-5 under the Advisers Act would make it unlawful for an adviser or certain of its executives or employees to engage in the following activities:

- Providing advisory services for compensation to a government client for two years after the adviser or certain of its executives or employees make a contribution to certain elected officials or candidates (with an exception for certain de minimis contributions by an executive or employee).
- Coordinating, or asking another person or political action committee to make: (i) a contribution to an elected official (or candidate for the official's position) who can influence the selection of the adviser, or (ii) a payment to a political party of the state or locality where the adviser is seeking to provide advisory services to the government.
- Paying a third party, such as a solicitor or placement agent, to solicit a government client on behalf of the adviser.
- Engaging in pay-to-play conduct indirectly, such as by directing or funding contributions through third parties such as spouses, lawyers or companies affiliated with the adviser, if that conduct would violate the rule if the adviser did it directly.

If adopted, the proposed rule would apply to investment advisers registered or required to be registered with the SEC as well as unregistered advisers relying on the de minimis exemption under Section 203(b)(3) of the Advisers Act. The proposed rule would cover not only situations where an adviser directly manages or advises a government entity's assets, but also situations where an adviser manages or advises a private fund or mutual fund in which the government entity invests its assets.

The SEC has also proposed rule amendments that would require advisers to maintain certain records of political contributions made by them or certain of their executives or employees.

SEC Backs *Gartenberg* Standard in Supreme Court Case

BY PATRICK LAVELLE

For over two decades the Second Circuit's *Gartenberg* decision has set forth guiding principles for reviewing lawsuits brought under Section 36(b) of the Investment Company Act. Now, with oral arguments before the Supreme Court in *Jones v. Harris Associates* set to begin November 2, 2009, the SEC and Department of Justice have filed jointly an amicus brief, on behalf of the United States, disagreeing with the Seventh Circuit's rejection of the Gartenberg standard.

The SEC finds two fundamental flaws in the Seventh Circuit's decision. First, the SEC disagrees that the adviser's fiduciary duty under Section 36(b) is limited to complete and accurate disclosure of information related to the advisory contract. Second, the SEC disagrees that "the only suitable benchmark" for evaluating the reasonableness of the adviser's fees are the fees paid by comparable investment companies.

In its brief, the SEC counters that a fully informed board's approval of compensation is not conclusive and does not guarantee against a fiduciary breach under Section 36(b). Rather, there must be an analysis of all relevant circumstances, as indicated in *Gartenberg*, to determine whether compensation received by the adviser is within a range of fees that arm's-length bargaining might have produced. In conducting that inquiry, the SEC contends that there should be a review of not only the fees paid by other investment companies, but also the fees the adviser charges unaffiliated clients for comparable services, if applicable.

In sum, the SEC advocates the view that while a board's approval is not determinative, its receipt of necessary information and its careful consideration of the *Gartenberg* factors when approving advisory compensation is "strong probative evidence that the adviser has complied with its fiduciary obligation."

Court Follows *Gartenberg* in Post-*Harris Associates* Decision

BY STEPHANIE FICHERA

In *In re American Funds Fee Litigation*, a recent decision by the U.S. District Court for the Central District of California, investors in several American Funds mutual funds brought a derivative action against a registered investment adviser and its subsidiary, a registered broker-dealer and American Funds' distributor and underwriter, alleging that they breached their fiduciary duties to investors under Section 36(b) of the Investment Company Act of 1940 in connection with various fees charged to the funds.

Gartenberg standard overshadows Seventh Circuit decision

The court elected to apply the standard for a Section 36(b) case set forth by the Second Circuit in *Gartenberg v. Merrill Lynch Asset Management, Inc.*, notwithstanding contrary law in the Seventh and Eighth Circuits and the court's recognition that *Gartenberg* "establishes a barrier so high that the Court [could find] no instance where an investor/plaintiff successfully met that burden." The court rejected the Seventh Circuit's *Jones v. Harris Associates L.P.*, which is presently under review by the U.S. Supreme Court, on the ground that its standard created an even higher burden for investors. The court likewise rejected the Eighth Circuit's *Gallus v. Ameriprise Financial, Inc.*, arguing that it created a cause of action broader than what is contemplated by Section 36(b).

Applying the several factors outlined in *Gartenberg* for deciding Section 36(b) cases, the court held that plaintiffs failed to meet their burden of proving that defendants had breached their fiduciary duties to investors. The court supported its decision with the following findings: plaintiffs failed to present sufficient evidence to prove that the nature and quality of defendants' services were lacking or disproportionate to the fees charged; the funds' profitability to the investment adviser was within the range deemed acceptable under Section 36(b); plaintiffs failed to show that economies of scale existed and were not adequately shared with investors; and defendants showed that their unaffiliated directors were sufficiently independent and conscientious to satisfy *Gartenberg*.

Temporary Money Market Fund Disclosures Adopted

BY ED ZAHAREWICZ

The SEC has adopted an interim final temporary rule that requires money market funds to report their portfolio holdings and valuation information to the SEC under certain circumstances. Temporary Rule 30b1-6T under the Investment Company Act, which became effective on September 18, 2009, is designed to provide information substantially similar to that submitted by certain money market funds under the Treasury Department's Temporary Guarantee Program for Money Market Funds. The Guarantee Program, which expired on the new rule's effective date, was established to allay investor concerns about the safety of money market funds in the wake of last year's Lehman Brothers bankruptcy and deepening credit crisis by guarantying the $1.00 share value of accounts held by investors as of September 19, 2008 in participating money market funds.

Under the rule, if the market-based NAV per share of a money market fund falls below $.9975, the fund must notify the SEC and provide it with a portfolio schedule containing the required information no later than the next business day. Thereafter, the fund must provide the SEC a portfolio schedule as of the last business day of each week, no later than the second business day of the following week, until the fund's market-based NAV per share is $.9975 or greater. The required notice and portfolio schedule, which is required to be prepared in Microsoft Excel format, must be submitted by email to a designated SEC email address. The rules states that the information submitted will be nonpublic to the extent permitted by law. The SEC believes that this information will enable it to identify funds that present a greater risk that they will be unable to maintain their primary investment objectives.

The disclosure requirements apply to every registered investment company or fund series that is regulated as a money market fund under Rule 2a-7, whether or not the fund had participated in the Treasury's Guarantee Program. Temporary Rule 30b1-6T, by its terms, will expire on September 17, 2010.

Summary Prospectus Satisfies Requirement

BY STEVE KRAUS

Summary prospectus is compliant

Section 404(c) of ERISA provides that a plan fiduciary is not liable for any losses resulting from investment decisions made by participants under an individual account plan (e.g., 401(k) plan) if the plan permits participants to exercise control over the assets in their accounts. Under the Department of Labor regulations implementing Section 404(c), in order for participants to be considered as having exercised control over their assets they must, among other things, be provided, or have the opportunity to obtain, sufficient information to make informed investment decisions.

If an individual account plan offers mutual funds as investment alternatives, participants must be provided by the plan fiduciary, either immediately before or immediately after a decision to invest in a mutual fund alternative, a copy of the most recent prospectus provided to the plan for that fund. The DOL regulations also provide that a participant must be provided, either directly or upon request, based on the latest information available to the plan, copies of any prospectuses, financial statements and reports, and any other materials relating to all the mutual fund investment alternatives available under the plan, to the extent such information is provided to the plan.

The SEC recently published Rule 498 providing for an enhanced disclosure framework for mutual funds including a new Summary Prospectus rule. The new Summary Prospectus rule is an optional means of compliance with the prospectus delivery requirements under section 5(b)(2) of the Securities Act.

In ERISA Field Assistance Bulletin No. 2009-3, the Labor Department announced that the delivery of a Summary Prospectus satisfies the requirement that a participant be provided with sufficient information to make an informed investment decision because the required contents of the Summary Prospectus provide key information about a mutual fund to participants. Specifically, the Summary Prospectus will satisfy the regulatory requirement that a plan fiduciary furnish a prospectus immediately before or immediately after a participant's initial investment in a mutual fund. Also, if a participant requests a prospectus, and the most recent prospectus received by the plan is a Summary Prospectus, the plan fiduciary may provide such Summary Prospectus in satisfaction of the request.

Who Regulates Financial Planning?

BY MARILYN SPONZO

In its persistent crusade to cast financial planning as an investment advisory activity beyond the scope of broker-dealer regulation, the Financial Planning Association (FPA) recently challenged a FINRA enforcement action against Ameritas Investment Corporation for failing to supervise a registered representative who developed misleading financial plans. The plans in question recommended that customers use mortgages and home equity loans to fund variable universal life policies intended for college expenses and retirement. Ameritas was fined $100,000 and the registered representative was fined $60,000 and suspended for nine months. Although Ameritas was dually registered as a broker-dealer and investment adviser, the representative who produced the misleading plans was not registered as an investment adviser representative.

Waiting to see who's on call

In a letter to SEC Chairman Mary Schapiro, the FPA expressed concern over FINRA's expansion of regulatory jurisdiction to include financial planners, and urged the SEC to clarify that financial planning is an investment advisory activity subject to a fiduciary standard of care. In a cautiously worded response, SEC General Counsel David Becker declined to directly address the FPA's concerns, although a FINRA press release announcing the enforcement action trumpeted FINRA's intention to "aggressively pursue firms and individuals who use misleading financial plans to induce customers to purchase securities."

Adding to the confusion are statements made by the SEC and its staff over the years suggesting that investment advice provided by a broker-dealer in connection with financial planning services is not solely incidental to broker-dealer activity and therefore is subject to investment adviser regulation. And the SEC's Rule 202(a)(11)-1 specifically provided as much until it was vacated in its entirety in 2007 by the D.C. Circuit Court of Appeals. The court acted for reasons not relating to this issue, however, and the status of financial planning under the federal securities laws remains unclear.

Largest Madoff "Feeder" Agrees to Settlement

BY LIAM BURKE

The largest "feeder" to Bernard Madoff's Ponzi scheme, Fairfield Greenwich Group, recently agreed to settle civil charges brought against it by Massachusetts regulators. Fairfield Greenwich agreed to pay $8 million to settle fraud charges alleging that it failed to conduct adequate due diligence on Madoff's securities firm while misrepresenting to investors that it had conducted "rigorous" due diligence.

Reportedly, the $8 million will be used to reimburse the Massachusetts investors that the State was able to identify who became Madoff victims by investing through Fairfield Greenwich. The settlement apparently will provide full reimbursement of the victims' losses due to Fairfield Greenwich's Madoff investments, plus interest. Massachusetts regulators had previously rejected a similar settlement offer of $6 million from Fairfield Greenwich because officials were still trying to identify additional victims. While the settlement is clear that Fairfield Greenwich neither admits nor denies the allegations, Fairfield Greenwich agreed to pay a $500,000 civil penalty in addition to the $8 million in reimbursement. Massachusetts regulators have touted the settlement as the first investor relief ordered by a regulator in the Madoff scandal.

Fairfield Greenwich is still facing far more substantial litigation and has reportedly been in settlement discussions with additional parties including Irving Picard, the trustee liquidating Madoff's business. Picard filed suit against Fairfield Greenwich alleging that it realized more than $3 billion in fake profit from Madoff's Ponzi scheme. Moreover, additional suits have recently been brought against other parties as a result of their ties to Fairfield Greenwich and its association with Madoff. For example, recently Standard Chartered Plc was sued for allegedly negligently placing money with a fund run by Fairfield Greenwich.

Supreme Court to Clarify "Storm Warnings" of Securities Fraud

BY BEN SEESSEL

Courts generally apply a two-step analysis in determining when the statute of limitations begins to run on a federal securities fraud claim: (1) were there "storm warnings" sufficient to put a plaintiff on inquiry notice of possible wrongdoing; and (2) if so, did the plaintiff exercise reasonable diligence in attempting to discover information necessary to state a claim. The Third and Ninth Circuits, however, have recently held that before a plaintiff is placed on inquiry notice, there must be "storm warnings" that defendant acted with scienter. No other circuit court of appeal has similarly held.

Unexpected reference to PSLRA a head-scratcher

The Supreme Court has granted certiorari in *In re Merck & Co. Securities, Derivative & ERISA Litigation*, in which the Third Circuit held that "to trigger 'storm warnings of culpable activity,' in the context of a claim alleging falsely-held opinions or beliefs, investors must have sufficient information to suspect that the defendants engaged in culpable activity, i.e., that they did not hold those opinions or beliefs in earnest." In a later case, the Third Circuit clarified that "Merck found that inquiry notice, in securities fraud suits, requires storm warnings indicating that defendants acted with scienter." The Ninth Circuit has held similarly in a recent case. Ironically, the Third and Ninth Circuit's decisions rely on the heightened pleading standards of the Private Securities Litigation Reform Act (PSLRA), which require that a plaintiff in a securities fraud case "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." This is an unexpected reference to the PSLRA, given that it was enacted with the general intent of reducing the number of securities fraud cases.

Scribner, Hall & Thompson, LLP

Possible Change to Section 530 Independent Contractor Safe Harbor in the Wind

BY JANEL FRANK

In H.R. 3408, introduced by Representative Jim McDermott (D-WA), is intended to limit the ability of taxpayers to utilize the independent contractor safe harbor provided by section 530 of the Revenue Act of 1978 (a non-Code provision). Currently, the section 530 safe harbor protects taxpayers who treat workers as independent contractors when the taxpayers historically and consistently treated its workers as independent contractors and had a reasonable basis for doing so. To establish a reasonable basis for independent contractor treatment, taxpayers can rely on court decisions and published rulings involving similarly-situated taxpayers, or technical advice and letter rulings directly involving the taxpayers. Taxpayers can also rely on the results from concluded audits and long-standing industry practices.

H.R. 3408 would significantly curtail the sources that could be relied upon to establish a reasonable basis for treating workers as independent contractors. Under H.R. 3408, safe harbor protection would only be available to taxpayers who treat workers as independent contractors on the basis of either a written determination from the IRS or a concluded audit. In addition, H.R. 3408 would terminate a taxpayer's ability to continue to rely on the written determination or concluded audit if facts and circumstances change, or if the Secretary subsequently issues contrary guidance. H.R. 3408 places the burden on the taxpayer to prove entitlement to the safe harbor by a preponderance of the evidence. Although not clear, it appears that the preponderance standard would only apply when a taxpayer is at risk of losing its entitlement to the safe harbor. For example, a taxpayer may need to prove by a preponderance of the evidence that its facts and circumstances have not changed since the initial determination of independent contractor status. If enacted, H.R. 3408 is expected to be a "small" revenue raiser.

Whistleblowers May Rule

BY TOM LAUERMAN

Pending regulatory reform proposals would give "whistleblowers" unprecedented opportunity and incentive to make trouble for broker-dealers, investment advisers, investment companies and other persons who are subject to the federal securities laws.

Under the proposals, if original information voluntarily provided to the SEC by a whistleblower leads the SEC to bring an administrative or judicial action that results in monetary sanctions exceeding $1 million, the SEC could reward the whistleblower with as much as 30% of the monetary sanctions resulting from the action (and any related actions). In order to be potentially eligible for such an award, a whistleblower need not be an officer or employee of the subject firm, but could instead be, for example, a service provider or any other person having knowledge of the firm's affairs.

These proposals could have numerous perverse consequences, including:

- Individuals who could prevent, remedy, or promptly report improper conduct might instead delay, in hopes that the matter would ultimately ripen into a much more serious problem about which they could profitably inform the SEC.
- Where a whistleblower's testimony is relied on to establish the substance of any violation, the potential reward would incentivize false testimony. And multiple whistleblowers could conspire to corroborate each others' false testimony and be rewarded for doing so.
- Because the proposal would give the SEC broad discretion whether to make awards and in what amounts, the SEC would face the conflict of controlling the compensation of whistleblower-witnesses in proceedings to which the SEC is a party.
- Although the proposals would prohibit any award to a whistleblower who was criminally convicted in the matter, criminal securities law convictions are rare. It would appear possible that awards could be made to "whistleblowers" who themselves were culpable in the matter, though not criminally convicted.

These proposals, which are currently being considered by Congress as part of the proposed Investor Protection Act of 2009, have received far less critical attention than they deserve.

SEC Limits Affiliate Marketing

BY PATRICK LAVELLE

The SEC's newly-adopted Regulation S-AM goes into effect June 1, 2010, which will limit the ability of certain financial firms to use for marketing purposes any consumer "Eligibility Information" received from the firms' affiliates. The new restrictions will apply to "Covered Persons," which include brokers, dealers, investment companies, investment advisers and transfer agents.

The SEC's current privacy regulation (Regulation S-P) limits financial firms' sharing of nonpublic personal financial information about a consumer with other persons, but generally permits such sharing among affiliates. Regulation S-AM will not change this, in that consumer Eligibility Information that is not used to market products or services may be freely shared among affiliates as permitted under Regulation S-P without complying with Regulation S-AM requirements.

Under Regulation S-AM, however, a Covered Person may use Eligibility Information received from an affiliate to make a marketing solicitation only if the consumer:

- is provided a "clear and conspicuous" notice of the information's intended use;
- is provided a reasonable opportunity and method for opting-out of receiving marketing solicitations; and
- does not make such an "opt-out" request.

The notice required by Regulation S-AM may be combined with other disclosures, including the annual privacy notice required by Regulation S-P.

The scope of the Eligibility Information that is subject to Regulation S-AM is not entirely clear.

Under the applicable definitions, Eligibility Information generally includes information bearing on a consumer's creditworthiness, credit standing, credit capacity, character, general reputation, personal characteristics or mode of living that is used or expected to be used or collected in whole or in part for the purpose of serving as a factor in establishing the consumer's eligibility for credit or insurance to be used primarily for personal, family or household purposes, employment purposes or other purposes as authorized by the Fair Credit Reporting Act. The SEC so far has declined to provide much guidance on the meaning of this definition.

Smoke-and-Mirrors of "Juridical Link" Doctrine Won't Save Plaintiffs Who Lack Standing

BY JAMES KIRTLEY

In *Neese v. Lithia Chrysler Jeep of Anchorage, Inc.*, a putative class action alleging that four car dealerships failed to make statutorily-required disclosures in connection with the sale of used cars, the Supreme Court of Alaska held that the plaintiffs could not rely on the "juridical link" doctrine to establish standing against two of the dealerships, because the plaintiffs had not alleged that class representatives actually purchased vehicles from those dealerships. The juridical link doctrine is an exception to the general rule that a class action plaintiff with no cause of action against a particular defendant cannot fairly and adequately protect the interests of those who do have a cause of action. The doctrine is sometimes applied when all the defendants in an action are "juridically related" in a manner suggesting that a single resolution of the controversy would be "expeditious."

In *Neese*, the plaintiffs argued that the four defendants were juridically linked by common ownership and, therefore, had sufficient standing to maintain suit against the two dealerships regarding which they made no allegations of purchase of vehicles. In rejecting the argument, the Alaska Supreme Court observed that the juridical link doctrine has no bearing on issues of standing; it is instead a doctrine "intended to be applied only in the context of class certification" to the questions of typicality and adequacy of representation. The court also noted that if the plaintiffs had wished to sue the dealerships for collective wrongdoing, they should have also named the umbrella corporation that owned them.

More than Lack of Conflict Required to Represent Class

BY LARA O'DONNELL GRILLO

In *Spinelli v. Capital One Bank*, the Middle District of Florida denied class certification on grounds that the plaintiffs failed to show they were adequate class representatives. Adopting the magistrate judge's report and recommendation, the court held that, although plaintiffs did not have an apparent conflict with the class, they nevertheless failed to meet the adequacy requirement of Federal Rule 23(a)(4). The court noted that the adequacy requirement encompasses two separate inquiries:

Named plaintiffs must show they are adequate class representatives

(1) whether any substantial conflicts of interest exist between the representatives and the putative class, and
(2) whether the representatives will adequately prosecute the action.

Plaintiffs failed to meet the second requirement, Specifically, the court found that plaintiffs presented no evidence, that they understood the responsibility inherent in representing potentially hundreds of thousands of unnamed class members, and they failed to establish that they understood the case and were willing and able to take an active role in the litigation. The case stands in contrast to those opinions which focus exclusively on the conflict-of-interest element of the class certification rule's adequacy prong and thereby relieve plaintiffs from their burden of establishing that they will adequately prosecute the action.

Preemptive Motion to Deny Class Certification Approved

BY TODD FULLER

In *Vinole v. Countrywide Home Loans, Inc.*, the Ninth Circuit ruled that a defendant may file a preemptive motion to deny class certification before the plaintiffs move for class certification. The plaintiffs had sought to represent a class of current and former Countrywide employees who were employed as "External Home Loan Consultants." The plaintiffs alleged that Countrywide had misclassified the employees as "exempt" outside sales employees and had failed to pay them overtime and other wages in violation of the Fair Labor Standards Act and state law. Several months before discovery and pretrial motion cutoffs, and prior to the plaintiffs filing any motion for class certification, Countrywide moved to deny class certification. The plaintiffs argued that the motion was "not ripe" and was procedurally improper because they had yet to file a class certification motion. The trial court disagreed and granted Countrywide's motion, holding that it could decide the motion under Rule 23 notwithstanding its timing. The trial court determined that certification was not proper because determining each consultant's exempt status would require individualized analysis of how each consultant spent his or her time at Countrywide.

Motion to deny allowed regardless of "ripeness"

On appeal, the Ninth Circuit affirmed, holding that the plain language of Rule 23, which requires only that certification be addressed "[a]t an early practicable time," itself defeated the plaintiffs' argument that there is some per se rule that precludes preemptive motions to deny class certification. The court observed that this view was in accord with other federal courts that have granted similar motions, and it rejected the argument that the motion was "fundamentally unfair" because it was filed before the discovery and pretrial motion cutoff dates. The court concluded that the plaintiffs had failed to demonstrate any "procedural prejudice from the timing of the consideration" of Countrywide's motion, and they had conceded that they did not intend to conduct any additional discovery on class certification issues. The court also affirmed the trial court's ruling on the merits, holding that a highly factual, individualized analysis would be needed for each class member to determine whether that employee was properly characterized as "exempt."

What Happens Pre-CAFA Stays Pre-CAFA in the Fifth Circuit

BY MICHAEL WOLGIN

In *Admiral Insurance Co. v. Abshire*, a 17-year old case between the State of Louisiana (among others) and insureds and investors of three defunct financial firms, the Fifth Circuit rejected Louisiana's argument that an amended complaint with new class allegations and a demand for attorney's fees permitted removal to federal court under the Class Action Fairness Act. The case was originally filed in Louisiana state court by 1,383 plaintiffs, many of whom were subsequently dismissed. In 2008, the state court allowed an amendment to the complaint that included class allegations and a demand for attorney's fees. Louisiana removed the case under CAFA, notwithstanding its application only to "civil action[s] commenced on or after February 18, 2005." Louisiana argued that the amended complaint "commenced" a new lawsuit because it "resurrected" in the proposed class certain dismissed plaintiffs and claims and because it sought attorney's fees. The district court remanded the case, and the Fifth Circuit affirmed, holding that under Louisiana law a civil action is "commenced" when the original petition is filed, and that, unlike a newly-added defendant, Louisiana had sufficient notice of "resurrected" plaintiffs and claims such that no exception was warranted. The court also held that class allegations do not per se "commence" a new "civil action," and that no authority supported the position that a new action is "commenced" with a demand for attorney's fees. The Fifth Circuit disagreed with the Seventh, Eighth, and Tenth Circuits' use of "relation-back" analysis under Rule 15 of the Federal Rules of Civil Procedure to determine when a case is "commenced" for CAFA's purposes, explaining that CAFA is jurisdictional and primarily concerns sufficiency of notice, whereas "relation-back" of a proposed amended complaint primarily concerns fairness and the statute of limitations.

Multi-State Unjust Enrichment Class Actions Held To Be Improper

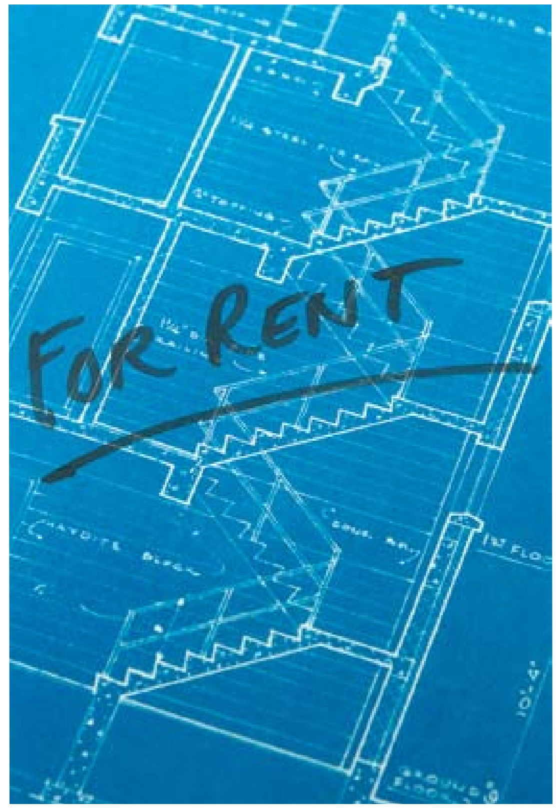
BY MICHAEL SHUE

In *Muehlbauer v. General Motors*, the U.S. District Court for the Northern District of Illinois recently ruled that "multi-state class actions for unjust enrichment are inappropriate because the individual states' laws regarding unjust enrichment are too nuanced to lend themselves to class treatment." In Muehlbauer, plaintiffs across 38 states alleged that General Motors defectively designed anti-lock braking systems used in certain vehicle models, failed to disclose the defect, and was unjustly enriched. Despite plaintiffs' unjust enrichment claims arising under the various state laws, plaintiffs failed to undertake any choice of law analysis and instead simply grouped states by legal similarity. The court denied plaintiffs' motion for class certification because the unjust enrichment laws varied too greatly from state to state. Quoting a previous decision of the same court, *In re Sears Roebuck & Co.*, the court explained that "unjust enrichment is a tricky type of claim that can have varying interpretations even by courts within the same state," let along among 38 different states. Among the variations that the court found to be important were state law differences regarding the requirement that no adequate legal remedy existed and whether or not the defense of unclean hands was permissible.

Arbitration Roundup

BY LANDON CLAYMAN

The Federal Arbitration Act severely limits the authority of courts to vacate or modify arbitration awards. In *AIG Baker Sterling Heights, LLC v. American Multi-Cinema, Inc.*, however, the Eleventh Circuit approved a way of getting around those limits that is available in some circumstances. During the arbitration of a dispute between a landlord and tenant over the amount of taxes owed by the tenant under the terms of the lease agreement, the tenant stipulated that it had not paid taxes for a certain six-month period, but discovered after the arbitration award was entered that it actually had paid taxes for that period. In federal court proceedings to confirm the arbitration award, the tenant persuaded the court to reduce the award by the amount of the taxes paid. The Eleventh Circuit reversed the modification of the award, holding that such relief was unavailable under the strict limitations of the FAA.



Landlord-tenant arbitration case provides new authority for courts

On remand, the district court entered a final judgment confirming the arbitration award in the original amount, but then granted a Rule 60(b)(5) motion reducing the judgment by the amount of the tax payment on grounds that the payment constituted a partial satisfaction of the judgment. On appeal, the Eleventh Circuit affirmed, ruling that the FAA provisions restricting the court's authority to review arbitration awards did not apply in such circumstances. Instead, the court pointed to section 13 of the FAA, which provides that judgments confirming arbitration awards are subject to all the provisions of law relating to those judgments, including Rule 60(b). In this instance, the court of appeals ruled, the district court was authorized to relieve the party from the judgment to the extent it had satisfied or discharged the judgment, even though the court had not been authorized to modify the arbitration award upon which the judgment was based.

NEWS & NOTES

Save the Date

Steve Kass, Partner in the Miami office, will be speaking at PLI Conference to be held in New York City on January 4-5, 2010. He will be discussing "Current Developments in Life Insurance and Annuities." More information is available at *www.pli.edu*

Joan Boros, of Counsel in the Washington, DC office, is presenting "Introduction and Securities Status and Classification of Insurance Products" at the PLI Conference Securities Products of Insurance Companies in the Face of Regulatory Reform 2010, January 29, 2010 in New York City. She is also the co-chair of the conference. More information is available at *www.pli.edu*.

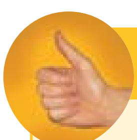
Speeches and Publications

ALI-ABA's 27th Annual Conference on Life Insurance Company Products was held November 5-6, 2009, in Washington, D.C. Miami Partner **Ann Black** presented "State Regulation of Annuities and Insurance: Suitability, Disclosure, Capital and Reserve, Life Settlement, and Insolvency and Rehabilitation Issues." Washington Partner **Gary Cohen** discussed the "Aftermath of Rule 151A: Securities Act Status of Insurance Products", Washington Partner **Richard Choi** is co-chair of the conference.

Robin Sanders, associate in the Washington, DC office, presented "Hot Topics in Life, Health, Disability and ERISA Litigation" at the DRI Annual Meeting, October 9, 2009.

Paula Cruz Cedillo recently presented at a CLE seminar offered by the National Business Institute entitled Comparison of Connecticut State and Federal Rules of Procedure and Evidence. Ms. Cedillo provided guidance and insight into the nuances of practicing law before both federal and state courts.

John Pitblado, associate in the Connecticut office, published "3rd Circuit Approves Settlement in Brokerage Antitrust Litigation" in the Harris Marting Reinsurance Report, October 2, 2009.



Announcing!

Jorden Burt is pleased to welcome six new associates.

Joining the Miami office, **Scott Byers** received his J.D. from the University of Miami School of Law and received his B.A. from the University of Massachusetts. **Clifton Gruhn** also received his J.D. from the University of Miami School of Law. He received his B.S. from Bellevue University. **Kimberly Freeman** also received her J.D. from the University of Miami School of Law. She received her B.S. from the University of Florida and was the Valedictorian of the College of Liberal Arts and Sciences.

Joining the DC office, **Jason Morris** received his J.D. from Georgetown University Law Center, and his B.B.A., magna cum laude, from Mercer University. **Scott Shine** received his J.D. from The Catholic University of America, Columbus School of Law and was awarded his B.A. from the University of Washington. **Paul Williams** also was awarded his J.D. from The George Washington University Law School, and his B.A. from the University of Oxford, Honor School of Modern History.

JORDEN BURT LLP

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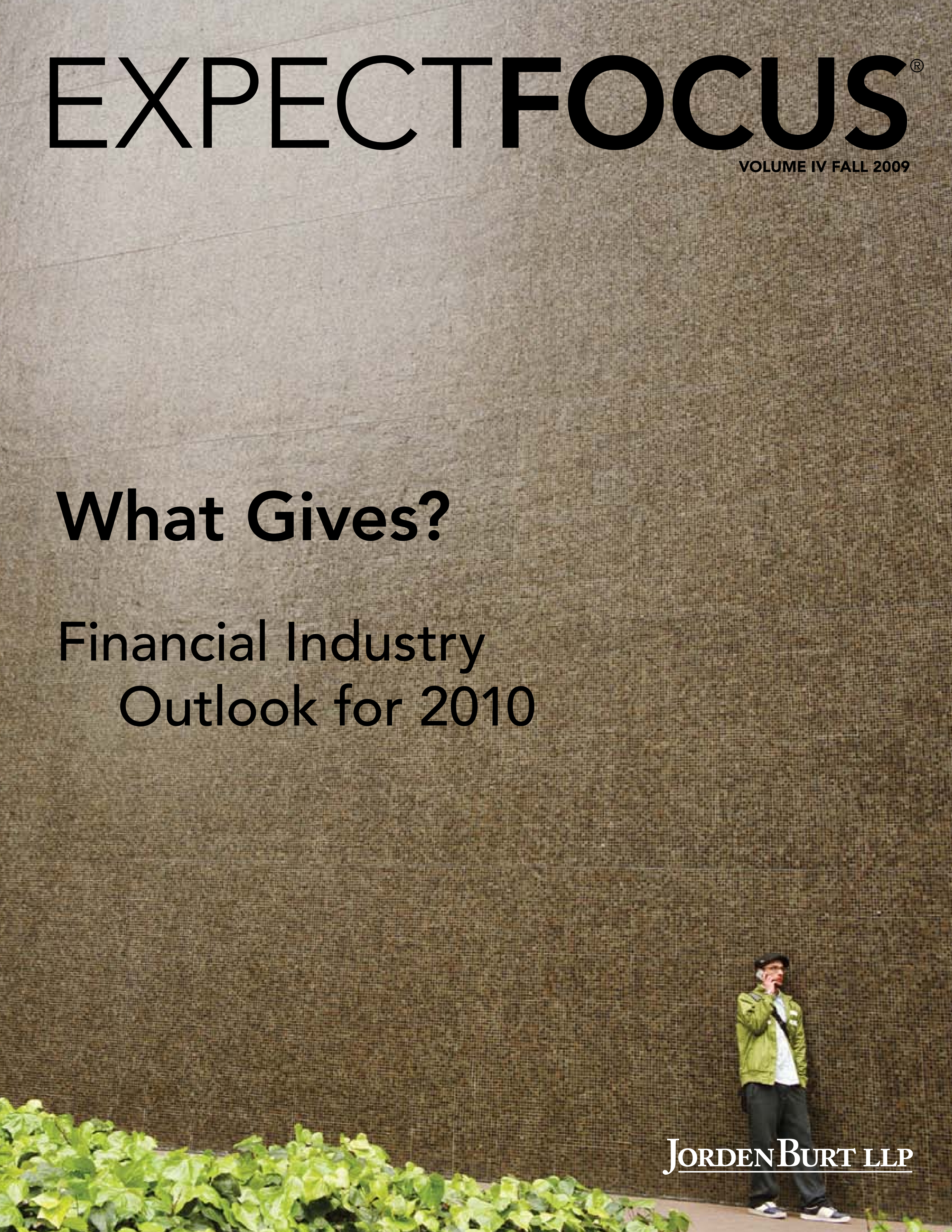

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