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INTHESPOTLIGHT

Unclaimed Benefit Practices Under Scrutiny

BY KRISTIN SHEPARD

Scrutiny of insurers' unclaimed benefit practices has sparked both proposed legislative changes by the National Conference of Insurance Legislators' Life Insurance & Financial Planning Committee (the NCOIL Committee) and class action litigation.

More cross-checks, investigation, and research for insurers?

The NCOIL Committee proposed amendments to the Beneficiaries' Bill of Rights **requiring that insurers identify deceased insureds of life insurance and owners of annuities and deceased retained asset account owners by checking the insureds' and owners' names against the Social Security Administration's (SSA's) Death Master File at least quarterly**. The amendment deems the SSA's Death Master File as constituting proof of loss and due notification of a claim. Within 45 days after finding a potential match or having reasonable belief that an insured or owner has died, the insurer must verify whether the death occurred and attempt to locate the beneficiary. Upon expiration of the relevant dormancy period – commencing on the date the SSA Death Master File match is verified – if no claim is paid, the insurer must remit unclaimed benefits/proceeds to the applicable state. The NCOIL Committee anticipates holding a meeting on the proposed amendments so that they may be presented to the NCOIL Executive Committee at the November national meeting.

Meanwhile, four putative class action lawsuits are challenging life insurers' unclaimed benefit practices and asserting that insurers have a duty to conduct annual sweeps of the SSA's Death Master File to proactively identify deceased policy-owners. The named plaintiffs – who are all alive – bring suit on behalf of living insureds who, because of their age, exceed a specified probability of death based on actuarial tables, and on behalf of deceased insureds for whom death benefits have not been paid.

The plaintiffs assert claims for unjust enrichment, breach of the duty of good faith and fair dealing, declaratory judgment and injunctive relief requiring insurers to conduct annual sweeps. The defendants filed motions to dismiss or for judgment on the pleadings, arguing that because the named plaintiffs are alive, they have suffered no cognizable injury and lack standing to pursue any claims related to defendants' unclaimed benefit payment practices. Defendants also argue that plaintiffs' claims are foreclosed by the plain language of their insurance policies, which state that the insurer's duty to pay death benefits is conditioned on its receipt of proof of the insured's death.

Plaintiffs filed the putative class actions in Ohio state court. The insurers removed the cases to the Northern District of Ohio under CAFA, and plaintiffs have moved to remand the cases to state court on the ground that CAFA's five million dollar amount in controversy requirement is not met.

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Recent Decisions in § 412(i) and § 419 Litigation

BY ENRIQUE ARANA & TODD FULLER

U.S. District Court: Opinions and predictions not actionable fraud.

The United States District Court for the Northern District of Texas recently issued several important decisions in MDL No. 1983, a multidistrict litigation proceeding designed to address claims related to employee benefit plans created under § 412(i) and § 419 of the Internal Revenue Code. For example, in two similar § 419 cases, the Court reaffirmed its earlier rulings and dismissed plaintiffs' fraud-based claims with prejudice. The Court concluded that the allegations that plaintiffs were induced to establish § 419 plans based on allegedly fraudulent representations that the plans would be valid and subject to favorable future tax consequences were simply non-actionable statements of opinion or predictions of future action. The Court explained that because plaintiffs could identify no law or IRS guidance that made plaintiffs' § 419 plan illegal when the policies were sold, **"any representations or omissions made … about the tax benefits or legality of the plans were not false when made but rather non-actionable opinions or predictions regarding future IRS enforcement."**

On a related note, the United States District Court for the Southern District of Florida recently granted the defendant insurer's motion for final summary judgment in a lawsuit relating to the use of insurance policies to fund defined benefit pension plans under § 412(i) of the Internal Revenue Code. In that case, plaintiffs established a § 412(i) pension plan and purchased insurance policies issued by the insurer to fund the plan. The IRS audited plaintiffs' plan and concluded that the plan failed to comply with § 412(i)(3) because it was "overfunded." Plaintiffs sued, arguing that the insurance policy was unsuitable for use in a § 412(i) plan. However, the court concluded that the § 412(i) plan's alleged noncompliance with § 412(i) was not caused by any incompatibility between the insurance policy and § 412(i). Rather, the IRS concluded the plan violated § 412(i)(3) because plaintiffs purchased too much insurance and overfunded the plan – a point which plaintiffs' own expert conceded. Plaintiffs also argued that the insurer had guaranteed that plaintiffs' § 412(i) plan would comply with § 412(i). However, the Court concluded that the insurer made no such promise and, to the contrary, repeatedly disclosed that it did not establish or administer § 412(i) plans; guarantee the validity of any such plans; or provide tax or legal advice regarding these plans.

Jorden Burt represented the defendant insurers in these cases.

Mark Your Calendar

The ABA TIPS Midwinter Symposium on Insurance, Employment and Benefits will take place January 12-14, 2012 in St. Pete Beach, FL. Jorden Burt associate **Robin Sanders** serves as chair-elect of the committee and four Jorden Burt partners will be presenting at the meeting. **Shaunda Patterson-Strachan** is speaking on "Hot Topics in the Life Insurance Industry" and **W. Glenn Merten** is moderating a panel called "Pre-Litigation Dispute Resolution: What is Working?" **Diane Duhaime** and **Michael Kentoff** are speaking on the "Social Media in the Life Insurance Industry" panel. For more information, visit *www.americanbar.org*.

STOLI Schemes Not Just For Policy Inception Anymore

BY DAWN WILLIAMS

The New York Department of Insurance's February 2011 letter disallowing an insurer from blocking the conversion of a term policy was a wake-up call for insurers and a reminder that **STOLI concerns can arise throughout the life of a policy**. In that letter, the department required the insurer to convert the policy despite the fact that the insured expressly intended to sell the policy to a third party investor immediately afterwards.

Insurers must remain focused on potential STOLI scenarios.

The Central District of California recently denied an insurer's motion to dismiss a claim on similar facts, where the plaintiff was a third party that had contracted with a policy owner to facilitate the purchase of a term policy shortly after it was converted into a universal life policy. The insurer had initially issued the new policy, but upon receiving the request for assignment of policy benefits to the third party, had terminated the policy and returned the conversion premium.

The insurer settled with the policy owner for the amount of funds that it was to receive from the investor after receiving a letter from the California Department "reminding it of its obligation under California's Life Settlement Act" to refrain from delaying the settlement. The third party investor then brought suit, and the insurer moved to dismiss. The court denied the motion to dismiss on all counts, finding that plaintiff had adequately alleged that it was the policy owner, and that the insurer had interfered with its contractual relationships, restrained trade in violation of the Cartwright Act and/or violated the UCL.

Delaware – A Tough STOLI State

BY DAWN WILLIAMS

Delaware's not hearing it!

The Supreme Court of Delaware recently sided with the insurer in answering three certified questions in two companion STOLI cases. In both cases, the insurer had brought a declaratory judgment action in federal court seeking to void the policies. The federal court denied the motions to dismiss and certified in both cases the question of whether a life insurance policy based on a lack of insurable interest can be contested after the expiration of the contestability period. The state court answered yes, finding that **a policy lacking an insurable interest is void and never came into force, making the incontestability provision inapplicable**.

The remaining two questions were only addressed in one of the cases. The first question was whether Delaware law would prohibit an insured from procuring a policy and immediately transferring it to a person without an insurable interest. Reconciling the Delaware insurable interest statute with the state Constitution, the court found that a third party having no insurable interest cannot use the insured as a means to procure a life insurance policy that would otherwise be prohibited. Rather, where the third party is actually using the insured as an instrumentality to procure the policy, the policy can only be valid if that third party has an insurable interest in the life of the insured.

The final question was whether a trustee has an insurable interest where the insured intends to transfer beneficial interest in the trust to a third party investor at the time the trust is created. Due to recent statutory amendments, the court answered the question in the affirmative only if the trust was created and initially funded by an individual with an insurable interest.

Retained Asset Account Litigation Update

BY ROBIN SANDERS

U.S. Courts of Appeals recently issued key rulings for the insurer defendants in two cases challenging insurers' use of retained asset accounts (RAAs) to pay ERISA-governed life insurance benefits. First, the Second Circuit issued its highly anticipated decision in *Faber v. Metropolitan Life Insurance Company*, in which it affirmed the district court's dismissal of the plaintiffs' putative class action complaint. In doing so, the court held that MetLife could not, as a matter of law, be held liable for breaching its ERISA fiduciary duties because, among other reasons, the express terms of the plaintiffs' ERISA-governed plans permitted MetLife to pay benefits through RAAs. As part of its decision, the court adopted the Department of Labor's opinion that **the key inquiry for resolving challenges to an insurer's use of RAAs is whether the terms of the ERISA-governed plan permit the payment of benefits in such a manner**.

Payment of benefits defined by plan terms.

In *Otte v. Life Insurance Company of North America*, the First Circuit accepted the defendant's Rule 23(f) petition seeking appellate review of the District of Massachusetts's June 2011 certification of two Rule 23(b)(3) subclasses. Particularly because the district court's class certification decision included a significant discussion related to the merits of the plaintiffs' claims, the First Circuit's acceptance of this Rule 23(f) petition is significant; as it raises the possibility that the First Circuit may clarify the scope of its decision in *Mogel v. UNUM Life Ins. Co. of America*, the seminal case relied upon by plaintiffs challenging insurers' ability to pay ERISA-governed benefits through RAAs. The defendant's initial briefing in this appeal is due in November, and thus a decision is not expected until 2012.

NAIC Developments – Burning up the Telephone Lines

BY STEVEN KASS

After Hurricane Irene forced the cancellation of the NAIC Summer National Meeting, various NAIC Committees, Task Forces and Working Groups met via conference calls in September and October to advance important initiatives, including:

- The Executive (EX) Committee and Plenary approved revisions to the Annuity Disclosure Model Regulation that add standards for fixed and fixed index annuity illustrations and expand the Model's scope to include variable and other registered products. They also approved an NAIC Sample Bulletin regarding Stranger-Originated Annuity Transactions.
- The Life Insurance and Annuities (A) Committee and the Financial Condition (E) Committee, along with several of their Task Forces and Working Groups, continued to review issues arising out of a "growing trend" to issue non-unit linked products, including BOLI/COLI, group pension, and annuity products that are supported by separate accounts. The Life Actuarial Task Force (LATF) sent the E Committee a memorandum outlining relevant issues and seeking additional guidance from the E Committee, which the E Committee plans to discuss during the Fall National Meeting.
- The A Committee discussed a LATF referral on contingent annuities that raised issues regarding the classification of this product, regulatory risks, consumer issues, and reserving and capital considerations, and it will continue these discussions during the Fall National Meeting.
- The Market Regulation and Consumer Affairs (D) Committee adopted revisions to the Market Regulation Handbook regarding annuity suitability and retained asset accounts examination standards. Its Social Media (D) Working Group published a draft White Paper on "The Use of Social Media in Insurance" addressing insurers' and producers' use of social media and regulatory compliance issues that will be discussed during the Fall National Meeting.
- The E Committee adopted revisions to the Credit for Reinsurance Model Law and Model Regulation that added a ratings-based framework allowing a ceding insurer to take full statutory reinsurance credit for reinsurance ceded to a "certified" reinsurer, without the reinsurer posting full collateral. These revisions will be addressed by Plenary at the Fall National Meeting.

Dodd-Frank Update

BY ROLLIE GOSS

A number of activities of potential significance have occurred in the implementation of the Dodd-Frank Act:

Systemic Regulation of Companies:

- The Financial Stability Oversight Council has a final rule exposed for comment addressing the factors and process for the designation of certain non-bank financial companies for supervision and prudential regulation by the Federal Reserve. It proposes a three step process, with all companies with total consolidated assets of more than $50 billion that satisfy one or more of five financial ratios or thresholds satisfying the first step of the process, with no exemption for any industry or type of company.

- The Federal Reserve has approved a final rule requiring that bank and non-bank financial companies which will be subject to its prudential regulation under Dodd-Frank prepare and submit a "resolution plan," i.e., liquidation plan, as required by Dodd-Frank.

Liquidation of Insurance Companies:

- The NAIC is considering for final approval guidelines for state insurance departments designed to assist departments in preparing to for the implementation of the receivership provisions of Dodd-Frank as they may apply to insurance companies. Although insurance companies would be liquidated pursuant to applicable state law, the timing of the initiation of a liquidation and certain administrative aspects of a liquidation would occur pursuant to the provisions of Dodd-Frank, and would occur much faster than in liquidations conducted strictly under existing state laws.

Insurance Regulation Modernization:

- Dodd-Frank requires that the Federal Insurance Office ("FIO") submit a report to Congress on how to "modernize" and improve the regulation of insurance in the United States, and the FIO has issued a request for comments on that topic. Although the FIO's Director has stated that his office is not an insurance "regulator" or "supervisor," the prospect of such a report may cause unease among some advocates of the state regulation of insurance.

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First Circuit Adopts Expansive View of I.R.C. § 197 with Respect to Covenant Not to Compete

BY LORI J. JONES

A recent decision in the U.S. Court of Appeals for the First Circuit agreed with the IRS (and the U.S. Tax Court) in holding that a "section 197 intangible" includes a covenant not to compete entered into in connection with *any* acquisition of a corporation's stock. I.R.C. § 197 generally provides that a section 197 intangible must be amortized, on a ratable basis, over the 15-year period beginning with the month in which such intangible was acquired. I.R.C. § 197(d)(1)(E) defines the term, "section 197 intangible," as including "any covenant not to compete … entered into in connection with an acquisition (directly or indirectly) of an interest in a trade or business or substantial portion thereof."

In *Recovery Group Inc. v. Commissioner*, the taxpayer argued that a section 197 intangible includes a covenant not to compete entered into in connection with the acquisition of only a substantial portion of a corporation's stock. Under the facts, the taxpayer, an S corporation, redeemed a shareholder who owned 23% of the corporation's stock and entered into a covenant not to compete which it amortized over the 12-month period of the covenant. The court found the statutory language ambiguous and looked to the legislative intent behind I.R.C. § 197. It held that a section 197 intangible includes a covenant not to compete acquired in connection with any acquisition of stock because goodwill and going concern generally constitute an essential component of each share of corporate stock (as opposed to an acquisition of assets where goodwill and going concern are likely to be present only in a substantial acquisition). Consequently, the court found that this interpretation of I.R.C. § 197(d)(1)(E) responded to Congress' intent to simplify the rules and reduce the amount of litigation surrounding these issues.

Multiple Plan Documents Relevant to Determining ERISA Standard of Review

BY W. GLENN MERTEN & JASON MORRIS

In an issue of first impression, the D.C. Circuit recently held that multiple ERISA plan documents may be examined to determine whether an administrator or fiduciary has discretionary authority to determine benefit eligibility. In *Pettaway v. Teachers Insurance & Annuity Ass'n*, a plan participant challenged the denial of disability benefits in connection with a previous back injury. In determining the appropriate standard of review, the district court examined the group disability plan, the summary plan description, and the group policy certificate. Finding that the plan and the summary plan description both granted the administrator discretionary authority, the district court applied a deferential standard of review and granted summary judgment to the defendant.

The participant appealed, arguing, inter alia, that a deferential standard of review was improper because her group policy certificate did not grant discretionary authority to the claims administrator. The D.C. Circuit disagreed, holding that it is appropriate to review at a variety of "plan documents" – in this case, all three documents reviewed by the district court – to determine the appropriate standard of review. **The appellate court reasoned that the text of ERISA clearly contemplates that multiple plan documents are legally relevant, and that other courts that have considered this question, including the Sixth, Seventh, Eighth, Ninth, Tenth, and Eleventh Circuits, have generally reached the same conclusion.** The court did not provide an exhaustive list of those plan documents that should be considered when determining the standard of review, but held that review of "multiple plan documents" is appropriate.

Accrual Date Set for COBRA Improper Notice Claims

BY W. GLENN MERTEN

The Eleventh Circuit Court of Appeals recently clarified the accrual date, for limitations purposes, of an improper notice claim under COBRA. In *Cummings v. Washington Mutual*, the court declined to find that the limitations accrual date occurred immediately after the COBRA notification period expired, holding instead that the applicable limitations period began to run when the plaintiff knew or should have known he sustained an injury. To hold otherwise, the court held, "would create the possibility that the limitations period will run out before a plaintiff even knows he has been injured."

Third Circuit Finds for Insurer in ERISA Appeal

BY W. GLENN MERTEN & PAUL WILLIAMS

In *Funk v. CIGNA Group Insurance*, the Third Circuit addressed and ruled favorably on several significant ERISA issues facing the industry. After paying LTD benefits for one year under the "own occupation" definition of disability incorporated in the ERISA plan, CIGNA denied Funk further benefits because he failed to satisfy the phase two "any occupation" disability definition. After Funk sued for improper denial of benefits, CIGNA counterclaimed, asserting an equitable lien to recover an overpayment pursuant to the plan's SSDI offset provision. On cross-motions for summary judgment, the district court held that CIGNA acted arbitrarily and capriciously in denying further benefits, that the denial was not supported by substantial evidence, that CIGNA had a conflict of interest, and that an equitable lien on the overpayment was not possible because the overpayment funds were dissipated prior to suit.

On appeal, the Third Circuit sided with CIGNA on all issues. The court held that CIGNA's actions were "reasonably consistent" with the Plan terms, and that those terms were unambiguous and required no further interpretation. The court also reiterated that under *Metropolitan Life Insurance Co. v. Glenn*, CIGNA's **"status as a third-party plan administrator does not automatically encumber it with a material conflict of interest." Since there was nothing to suggest a "meaningful conflict of interest,"** the District Court erred in giving "significant weight … to a largely hypothetical conflict," and remanded for a reevaluation of CIGNA's claim decision. Finally, the court held that pursuant to the Plan language, CIGNA held an equitable lien by agreement. Based on the Supreme Court's holding in *Sereboff v. Mid Atlantic Medical Services, Inc.* that there is no tracing requirement for an equitable lien by agreement, and that the subject property could be converted without affecting the lien, "dissipation of the funds was immaterial," and CIGNA could assert a equitable claim for recovery of the overpayment under § 502(a)(3).

Racially Disparate Impact of Race-Neutral Pricing Not Actionable

BY JACOB HATHORN

The Texas Supreme Court recently concluded in *Ojo v. Farmers Group, Inc.*, in response to questions certified to it by the Ninth Circuit Court of Appeals, that Texas law does not prohibit a property and casualty insurer from using race-neutral factors in credit-scoring to price insurance, even if doing so creates a racially disparate impact.

Mr. Ojo filed a class action against Farmers on behalf of himself and all other members of a racial minority whose homeowner's insurance premiums increased as a result of the insurer's use of a credit-scoring system that, while not intentionally discriminatory, was discriminatory in effect, and therefore allegedly violated the federal Fair Housing Act (FHA).

The District Court granted Farmers' motion to dismiss without reaching the merits of the disparate-impact discrimination claim, because it found that the claim was reverse-preempted by the Texas Insurance Code under the McCarran-Ferguson Act (MFA), which provides that "[n]o Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance." On appeal, the Ninth Circuit asked the Texas Supreme Court to weigh in on whether Texas law permits an insurer to price insurance by using a credit-score factor that has a racially disparate impact that, but for the MFA, would violate the FHA.

The Texas Supreme Court answered affirmatively. The court noted that the Texas Insurance Code, unlike the Texas Labor Code, does not include a separate provision creating a cause of action for disparate impact discrimination even though it is clear from applicable legislative history that both the state legislature and insurance commissioner were aware of the potential for disparate impacts. Accordingly, **the legislature did not intend to provide for disparate impact liability for the use of credit scoring in pricing insurance**. Allowing a claim against Texas insurers for using completely race-neutral factors in credit scoring would therefore frustrate the regulatory policy of Texas that the MFA is meant to protect, which is the continued regulation of the field of insurance by the states without unintentional congressional intrusion.

Insurance Coverage Battle Over Underlying Data Privacy Spurs Multiple Class Actions

BY ROBERT HELFAND

In a high-stakes battle, Sony Corporation of America is litigating the question of whether its failure to protect customers' personal information constitutes "publication" within the meaning of its liability coverage. **Sony operates online entertainment and gaming networks that have collected personal or financial information from more than 100 million users.** In April 2011, hackers gained unauthorized access to that information, resulting in at least 62 class action lawsuits in the United States and Canada.

The cases assert claims under state consumer protection and data security statutes, as well as for negligence, unjust enrichment and breach of warranty. The plaintiffs allege, among other things, that some customers' credit card information has been used without authorization; that customer information has been offered for sale on pirate or hacker websites; that Sony customers have been subjected to unwanted advertising; and that they have been forced to take measures and incur expenses to protect their personal data.

In July 2011, Zurich American Insurance Company filed a declaratory judgment action in New York State Supreme Court, disclaiming any obligation to defend or indemnify under Sony's primary and excess commercial general liability policies. Five days later, in California Superior Court, Sony filed a competing declaratory judgment action against Zurich and several excess insurers. Sony alleges that its primary policy defines "personal and advertising injury" to include "[o]ral or written publication, in any manner, of material that violates a person's right of privacy" and that alleged "disclosure … of, or unauthorized access to" such material constitutes "publication" within this definition. Sony also quotes allegations from the class action complaints, to the effect that Sony's actions harmed class members by causing public disclosure of "personal information." Sony and Zurich are each seeking dismissal of the other company's action.

NAIC Moves to Level the Collateral Playing Field

BY ANTHONY CICCHETTI

The NAIC's Financial Condition (E) Committee has adopted revisions to the NAIC's Credit for Reinsurance Model Law (#785) and Credit for Reinsurance Model Regulation (#786). **At the heart of the revisions is the addition of a ratings-based framework allowing a ceding insurer to take full statutory reinsurance credit for reinsurance ceded to a "certified" reinsurer, without the reinsurer posting full collateral as security for its payment obligations.** Adopted on September 19, 2011, the revisions track the July 26, 2011 drafts exposed by the Reinsurance (E) Task Force, with certain additional amendments to the Model Regulation made by both the Task Force and the Committee during their respective meetings on September 19. The revisions were scheduled to be considered by the NAIC Executive Committee and Plenary during the Fall National Meeting in early November.

Under the revisions, a reinsurer may apply for certification by a state's insurance regulator, with that state then assigning one of six possible ratings to the reinsurer upon certification. The assigned rating determines the minimum level of collateral required to be posted by the certified reinsurer for the ceding insurer to take full reinsurance credit, as follows:

Secure-1:	0% collateral required	Secure-4:	50% collateral required
Secure-2:	10% collateral required	Secure-5:	75% collateral required
Secure-3:	20% collateral required	Vulnerable-6:	100% collateral required

To be eligible for certification under the revised Models, the reinsurer must:

- Be domiciled and licensed in a qualified jurisdiction,
- Maintain minimum capital and surplus of $250,000,000,
- Maintain financial strength ratings from at least two approved rating agencies,
- Agree to submit to the state's jurisdiction, and
- Agree to prescribed information filing requirements.

In determining whether a reinsurer is domiciled in a qualified jurisdiction, a state may independently assess non-U.S. jurisdictions in accordance with the Model Regulation's standards or defer to a list published by the NAIC. U.S. jurisdictions that meet the requirements for NAIC accreditation are recognized as qualified jurisdictions. Although not the sole factor to be considered, financial strength ratings issued by approved rating agencies play a major role in the reinsurer's state certification. The lowest financial strength rating from an approved agency will establish the maximum possible state rating for the certified reinsurer, in accordance with a table in the regulation that sets forth the maximum state ratings corresponding to the various possible agency ratings. (For example, a reinsurer with a rating of A+ from Best and A1 from Moody's would be eligible for no higher than a Secure-3 state rating.) You will find a more extensive summary and analysis of these revisions in a *Special Focus* article at *ReinsuranceFocus.com*.

New York Certifies Reinsurers For Reduced Collateral

BY ANTHONY CICCHETTI

Effective January 1, 2011, New York's Tenth Amendment to 11 NYCRR 125 (Regulation 20) effected a ratings-based framework allowing ceding insurers to take full statutory financial statement credit for reinsurance ceded to certain unauthorized reinsurers without the reinsurers posting full collateral. As of September 26, 2011, the New York Department's website listed **14 Certified Reinsurers that have met the regulation's requirements for reduced collateral.** Of these 14, three achieved a Secure-2 rating, meaning they would be required to post collateral at a 10% level to allow the ceding company to take full reserve credit. The remaining Certified Reinsurers achieved a Secure-3 rating, which puts the collateral requirement for them at 20%. Property and casualty companies dominated the list. Ten of the Certified Reinsurers were certified for property/casualty business, two were certified for life, annuities, and accident/health lines, and the remaining two for property/casualty and life, annuities, and accident/health.

Follow the Fortunes Doctrine Requires Reinsurer to Take a Bath with Cedent

BY JOHN PITBLADO

Multi-billion dollar exposure from numerous asbestos and silica exposure lawsuits ultimately forced Dresser Industries into bankruptcy. In the course of the bankruptcy proceeding, Dresser commenced a declaratory judgment action against its liability insurers, seeking to establish their respective coverage obligations. The several insurers ultimately participated in a global settlement of the coverage case, at a figure determined by an outside consultant hired by the group of settling insurers.

One of the settling insurers, Lexington Insurance Company, which had issued a coverage "tower" to Dresser consisting of multiple policies (each covering different layers of the risk), used a "bathtub" method of allocation to determine which of its policies would contribute to its share of the settlement, and in what amounts. By this method, its exposed policies were layered (as though in a bathtub) according to their layers of coverage, and those that were "underwater" given the settlement structure were tendered to their limits. Based on this analysis, Lexington paid out the limits under two separate $10,000,000 policies.

Lexington then looked to its reinsurer, Skandia America Reinsurance Company (later known as Clearwater Insurance Company), for coverage under a facultative certificate issued to Lexington reinsuring the two policies at issue. Clearwater denied Lexington's claim on the basis that Lexington's "bathtub" methodology was contrary to the recommendations of the outside consultant that determined the ultimate global settlement, and that if the recommended method were used, the exposures on the two Lexington policies reinsured by Clearwater would have been greatly reduced. In *Lexington Insurance Co. v. Clearwater Insurance Co.* (July 26, 2011), the court found in Lexington's favor, concluding that **under the "follow the fortunes" doctrine, which requires a reinsurer to cover settlements made by the reinsured "so long as they are not fraudulent, collusive, or made in bad faith," there was nothing inherently unreasonable about Lexington's chosen allocation method**, and that there was no evidence of bad faith or the like.

Arbitration Award Gives Cedent More Than It Bargained For

BY BEN SEESSEL

In *Harper Insurance Ltd. v. Century Indemnity Co.*, the District Court for the Southern District of New York denied the motion of a group of reinsurers to vacate an arbitration award requiring the reinsurers to promptly pay all disputed and undisputed claims, notwithstanding that the parties to the reinsurance agreement had not contracted for such provision. The London market reinsurers had entered into a reinsurance treaty with Century Indemnity Company, indemnifying the insurer for liabilities arising out of asbestos litigation. The treaty did not contain a "Reports and Remittances" clause dictating when claims should be paid, but provided that the "liability of the Reinsurers shall follow that of the Company in every case." The treaty also included an "honorable engagement" clause, directing arbitrators adjudicating disputes to interpret the agreement to effect its general purpose.

Facing significant losses due to a flood of asbestos litigation, the reinsurers created a program whereby Century would have to meet documentation requirements before claims were paid. When payments became delayed, Century initiated arbitration. The arbitrators issued an interim order requiring the reinsurers to promptly pay 100% of all undisputed claims and 75% of any disputed claims, finding that such arrangement would effectuate the general purpose of the treaty. After several years of paying claims pursuant to this arrangement, the reinsurers moved to vacate the award when the arbitrators, who had retained jurisdiction to modify their order, rendered the award final. **Citing the "honorable engagement" clause, the district court denied the motion to vacate and confirmed the award, holding that the arbitrators had the power to fashion the remedy, even though it included obligations not explicitly bargained for by the parties.**

Uniform Investment Adviser Regulation Proves Elusive

BY TOM LAUERMAN

It seems increasingly likely that some types of investment advisers will be required to be members of a self-regulatory organization (SRO). **Whatever virtues this may have, uniformity of regulation will probably not be among them.**

Investment advisor regulation could get even more confusing.

Draft legislation released by Congressman Spencer Bachus, Chairman of the House Financial Services Committee, generally would require investment advisers that are SEC-registered (or that would be SEC-registered if they were not state-registered) to be SRO members.

An exemption would apply, however, if more than 90% of the adviser's assets under management are attributable to mutual funds, various other types of pooled investment vehicles, and/or other clients with investments of at least $25 million each. Moreover, the Bachus draft states that the SEC could extend this exemption to cover any other advisory affiliates whose operations and compliance programs are sufficiently integrated with those of the exempt adviser.

The Bachus draft exemption from SRO regulation would not, however, apply to any adviser that is registered with the SEC as a broker-dealer (or that is controlled by any natural person that is registered with such a broker-dealer). Because such dually-registered" persons already are subject to FINRA regulation, many of them would prefer that FINRA (or a FINRA affiliate) be their SRO for purposes of satisfying any requirement such as that under the Bachus draft.

Other advisers continue to resist the SRO concept. This includes "independent" (i.e., non-broker-dealer) advisers whose clients have characteristics that would preclude reliance on the above exemption. If independent advisers must ultimately join an SRO, most would prefer it not be FINRA (or a FINRA affiliate). But FINRA is eager to maximize its membership (either directly or through an affiliate), and questions remain whether advisers will have any viable alternative.

All Atwitter Over Social Media Regulation

BY ANN FURMAN

Last August, when it issued part two of its social media guidance (Regulatory Notice 11-39), FINRA again identified the "business as such" requirement under Securities Exchange Act Rule 17a-4 as the trigger for its regulation of social media communications. So, for example, if a registered representative communicates via Twitter or Facebook, a firm should apply a "facts and circumstances test" to determine whether the communication relates to the broker-dealer's business as such. If it does, the representative's tweet or Facebook post must be "retained, retrievable, and supervised" by the firm.

While both FINRA and the SEC have sought to subject social media to the same regulatory approach as traditional forms of communication, **social media technology continues to evolve faster than securities regulation.** Some see the resulting regulatory approach as failing to strike an appropriate balance between regulatory costs and benefits. For example, it may be too costly or burdensome for a firm to apply a facts and circumstances test to each and every communication; there is not always a clear delineation between business and personal communications. Some firms have responded by prohibiting altogether the business use of social media by their associated persons.

For its part, the Investment Company Institute (ICI) has called for a comprehensive approach to electronic communications that reflects a strong understanding of evolving media and technological capabilities and appropriately considers the costs and benefits of regulation. The ICI recommends that consideration be given to a more flexible regulatory approach that does not require broker-dealers to supervise and maintain a record of every communication related to its business as such.

The ICI and its members have proposed working with FINRA and the SEC to modernize the regulatory approach to keep pace with technological advances. This would be a positive step.

GAO Demurs on Private Right of Action for Aiding and Abetting

BY BEN SEESSEL

The GAO has issued a report, mandated by the Dodd-Frank legislation, analyzing the impact if Congress were to create a private right of action for aiding and abetting securities law violations. The report takes no position on whether Congress should create such a private right.

Congress aiming big guns at "secondary actors"?

Aiding and abetting claims would be aimed at so-called "secondary actors" – the accountants, attorneys, underwriters, credit rating agencies, securities analysts, and others that assist companies in effectuating securities transactions. Under applicable Supreme Court decisions, only the SEC currently may bring federal securities law actions against such persons.

Dodd-Frank expanded the SEC's ability to pursue secondary actors by lowering the scienter requirement to prove aiding and abetting liability from "knowingly" to "recklessly," and by making civil penalties available in SEC enforcement actions. The GAO's report describes the evolution of the legal framework relevant to aiding and abetting under the federal securities laws.

Citing commentary from "stakeholders" and experts on either side of the issue, the GAO report discusses the policy arguments for and against creating a private right of action, including deterring fraud, compensating investors, and the effects on investors and the economy. Although the report also discusses possible measures that might mitigate potential negative effects, it does not provide much assistance in evaluating how the various competing considerations should be weighed against one another.

Toughened Requirements for Mutual Fund Ads?

BY GARY COHEN

FINRA may be looking into whether new disclosure requirements should be adopted to discourage investors from relying too heavily on past performance information in fund ads.

SEC Rule 482 under the Securities Act requires performance ads to advise that "past performance does not guarantee future results." But some academics, as revealed in a recent GAO report to Congress on fund advertising mandated by the Dodd-Frank Act, believe that this language should be toughened to warn that "high fund returns generally do not persist."

The GAO notes that FINRA's Office of Investor Education "has been considering conducting research to determine if disclosures can be used to encourage investors not to overly rely on past performance information" and that such research "could help inform regulatory change."

The GAO report stops short of actually recommending any such regulatory change. The only recommendation that the GAO makes is that the "SEC should take steps to ensure FINRA develops sufficient mechanisms to notify all fund companies about changes in rule interpretations for fund advertising."

The GAO report includes a letter from SEC Chairman Mary Schapiro stating that she has asked the staff "to consider the GAO's findings as part of the staff's ongoing oversight of FINRA." However, the Chairman's letter says nothing about changing the advertising rules.`

GAO addresses risk of relying too heavily on past performance.

Losing Streak in D.C. Circuit Impacts SEC Rule-Making

BY SCOTT SHINE

The dynamics of SEC rule-making are evolving in response to a string of defeats the agency has suffered due to deficiencies in its "cost-benefit" analyses. On three occasions since 2005, the D.C. Circuit has struck down rules based on the SEC's failure to adequately consider their effect on efficiency, competition, and capital formation as required by law.

Consequently, **commenters on proposed rules are increasingly framing their comments to build a record for challenging the rules in court**. These commenters draw inspiration from language in the cases that requires the SEC to consider comments seriously. For example, in its April 2011 decision overturning the SEC's proxy access rule, the D.C. Circuit faulted the SEC's economic analysis as "fail[ing] to respond to substantial problems raised by commenters."

Public comments carefully considered.

In part to address such problems, the SEC recently hired Kathleen Weiss Hanley as Deputy Director and Deputy Chief Economist within its Division of Risk, Strategy, and Financial Innovation (RiskFin). One important purpose for the SEC's creation of RiskFin in 2009, as well as the recent hiring of Ms. Hanley, has been to enhance the agency's capacity for economic analysis to inform the rule-making process.

Nevertheless, the SEC will continue to struggle to clear the rising bar for cost-benefit analyses, in view of budgetary limitations, the large number rule-makings on the SEC's plate, and commenters' increasingly adversarial posture. Moreover, these challenges would be compounded if The SEC Regulatory Accountability Act, which was introduced this summer by Congressman Scott Garrett (R-NJ), were to become law. Among other things, that legislation would call for the SEC to take into account several new considerations and follow specified additional procedures in an effort to ensure that the benefits of any rule justify the costs.

SEC Queries Public on Funds' Use of Derivatives

BY ED ZAHAREWICZ

Having, over the years, addressed of a number of issues relating to the use of derivatives by funds registered under the Investment Company Act of 1940 on an ad hoc basis, the SEC issued a concept release on August 31, 2011 in hopes of creating "a more comprehensive and systematic approach." In particular, the release seeks comments on the costs and benefits of the use of derivatives by funds, as well as the applicability of certain regulatory requirements under the Act. These include the Act's:

- Limitations on senior securities and leverage,
- Limitations on investments in securities-related issuers and issuers concentrated in a single industry,
- Requirements for portfolio diversification, and
- Provisions governing the valuation of fund assets.

Derivatives can be used to create leverage, but often pose a risk to other variables (such as to the credit of a counterparty and the performance of an underlying reference asset), and can be difficult to value. The release seeks input on these issues, including how they should be addressed when applying the Act's above-listed requirements. For example, the release questions whether the SEC's current "asset segregation" approach adequately addresses the investor protection concerns underlying the Act's limitations on leverage. The release also seeks input on potential alternative approaches to these concerns.

The SEC's concept release may portend significant changes in the way funds will be able to use derivatives in the future. In any event, it provides a useful compilation of current requirements and practices under the Act in connection with fund derivative use, as well issues of concern to the SEC in this area. Accordingly, compliance and risk management personnel should find the release helpful in implementing or reviewing current fund policies and internal controls.

Proposed Legislation Would Require Private Funds to Adopt AML Programs

BY MICHAEL KENTOFF & KAREN BENSON

The time may be approaching when unregistered investment companies must adopt anti-money laundering (AML) programs. The Treasury Department's Financial Crimes Enforcement Network (FinCEN) proposed a rule to that effect in 2002, but withdrew the proposal in 2008 without foreclosing the possibility of re-proposing the rule at some later time.

Senator Carl Levin (D-Mich) recently introduced the "Stop Tax Haven Abuse Act" in the Senate, and Congressman Lloyd Doggett (D-Tex) thereafter introduced a corresponding bill in the House. This pending legislation would, among other things, direct Treasury to adopt rules requiring unregistered investment companies to establish AML programs and to submit suspicious activity reports (SARs) in accordance with the USA Patriot Act.

Though the contemplated rules are aimed primarily at hedge funds and private equity funds, **the rules would apply to any issuer that would be an investment company but for the exclusions in Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940.** Thus, the contemplated rules also would apply to a variety of entities such as venture capital funds.

Current rules already require insurers to maintain AML programs and file SARs with respect to certain individual (but not group) insurance products, including variable products. The bill, if enacted, probably would not greatly affect such existing AML/SAR procedures pertaining to individual products.

Senator Levin has introduced iterations of this bill in previous congressional sessions, but the bill includes tax and other provisions that are more controversial than the AML/SAR requirements for private funds. It is not yet clear whether the time is ripe for such requirements, whether by legislation or by FinCEN rulemaking.

Mark Your Calendar

Jorden Burt attorneys are presenting at an upcoming seminar sponsored by the Practising Law Institute. **Joan Boros**, of counsel in the Washington office, serves as co-chair of the Securities Products of Insurance Companies and Evolving Regulatory Reform 2012 conference January 25, 2012 in New York City and will present "Insurance Product Design." **Richard Choi**, partner in the Washington office, will speak on the "Distribution of the Insurance/Securities Products; Advertising; and Ethics" panel. For more information, visit *www.pli.edu.*

Defendants' Failure To Attach All Papers Won't Defeat Removal

BY EDDIE KIRTLEY

The Tenth Circuit Court of Appeals recently held that remand is not required merely because a removing party fails to attach "a copy of all process, pleadings, and orders served upon [it]," as required by the removal statute, 28 U.S.C. § 1446(a). In *Countryman v. Farmers Insurance Exchange*, the defendants had filed a joint notice of removal pursuant to CAFA but failed to attach the summons served on one of the defendants. Shortly after the thirty-day removal period, the defendants supplemented their timely notice of removal with a copy of the missing summons. On the plaintiff's motion to remand, the district court held that the removal statute required strict compliance and that the failure to file the summons served on one of the defendants at the time of removal defeated removal.

Tenth Circuit not hung up on technical details.

Following the majority view, the Tenth Circuit reversed and held that the missing summons was "a de minimis procedural defect that did not necessitate remand of the case to state court." The court also found that **"this de minimis procedural defect was curable, either before or after the expiration of the thirty-day removal period,"** and that the defendants had in fact cured the problem when they supplemented their notice of removal with the missing summons. The court observed that the "[p]laintiff was not prejudiced by the [defendants'] omission," and "[n]or was the district court's ability to proceed with case materially impaired." The plaintiff also argued that the defendants failed to establish the jurisdictional minimum under CAFA, but the court remanded for consideration of that issue because the district court had not addressed it in its prior order.

Voluntary Dismissal of Underlying State Case Moots Federal Appeal

BY LARA O'DONNELL GRILLO

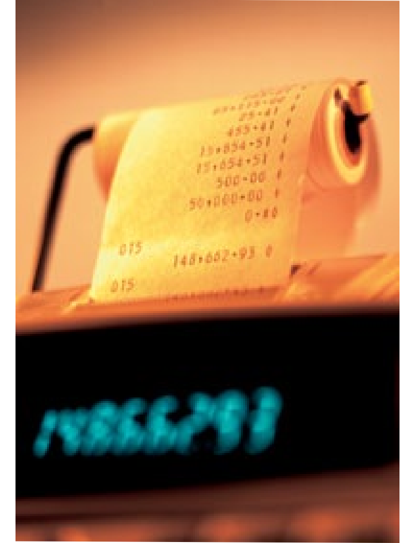
In a matter of first impression, the Tenth Circuit Court of Appeals held that plaintiffs' voluntary dismissal of its class action in state court rendered moot defendants' appeal of the district court's remand order. In *Dudley-Barton v. Service Corp. Int'l*, plaintiffs had filed a class action in state court based on claims of unlawful employment practices and policies. Defendants removed the case under CAFA, but the district court remanded, concluding that defendants failed to establish that the amount in controversy exceeded the $5 million jurisdictional threshold. Defendants petitioned the Tenth Circuit for leave to appeal the remand order. Before the Tenth Circuit granted the petition, plaintiffs voluntarily dismissed their claims without prejudice in state court. Four days later, the Tenth Circuit granted defendants leave to appeal, and plaintiffs moved to dismiss the appeal as moot. The Court of Appeals granted plaintiffs' motion, holding that **plaintiffs' voluntary dismissal in state court left no meaningful dispute between the parties, and the defendants no longer had a material interest in contesting the remand order**. It added that dismissal of the appeal was also appropriate because it could not provide meaningful relief to the defendants by reviewing the remand order.

Appeal of remand order requires ongoing dispute.

CAFA Bars Aggregation Across Class Actions

BY MICHAEL N. WOLGIN

In *Marple v. T-Mobile Central LLC*, the Eighth Circuit Court of Appeals held that class member claims cannot be aggregated across separate lawsuits for purposes of meeting the $5,000,000 jurisdictional amount in controversy under the Class Action Fairness Act. T-Mobile had filed ten separate lawsuits against Missouri municipalities for refunds of taxes paid in ten specific time periods. Subsequently, Marple and another consumer brought ten corresponding class action lawsuits in state court against T-Mobile for passing those taxes on to its consumers. T-Mobile removed the class actions to federal court, contending that the combined amounts in controversy across Marple's ten actions satisfied the $5 million requirement. The U.S. district court disagreed and remanded the cases back to state court.



Eight Circuit: No aggregation of claims to meet CAFA minimum.

The Eighth Circuit affirmed, explaining that CAFA is silent on whether class claims may be aggregated across class actions, but that **given "CAFA's detailed instructions" for aggregating claims within a single class action, "Congress would have similarly outlined how courts should aggregate between class actions had it intended for courts to do so."** The court distinguished a 2008 opinion from the Sixth Circuit, *Freeman v. Blue Ridge Paper Products, Inc.*, which aggregated amounts across several class actions that had been filed separately for the admitted purpose of circumventing CAFA. In contrast with Freeman, the Eighth Circuit explained, Marple's separate class actions were "driven by T-Mobile's own litigation decisions," and there was no "indication that Marple artificially divided the lawsuit to avoid the CAFA."

Courts Part Ways Over Removability of *Parens Patriae* Suits Under CAFA

BY BRIAN P. PERRYMAN

Two lines of cases bookend the divergent views on whether so-called "*parens patriae*" lawsuits can be removed to federal court under the Class Action Fairness Act. *Parens patriae* suits are civil actions brought by a state officer as the state's legal representative to vindicate the state's sovereign and quasi-sovereign interests, as well as the individual interests of the state's citizens. Because they are asserted on behalf of unnamed persons by a representative, *parens patriae* suits share some of the hallmarks of "class" or "mass" actions. A debate has arisen, however, as to whether *parens patriae* suits may be removed under CAFA.

In *West Virginia ex rel. McGraw v. CVS Pharmacy, Inc.*, the Fourth Circuit held that the West Virginia Attorney General's suit against pharmacies alleging violations of West Virginia's generic-drug pricing statute and Consumer Credit and Protection Act was **not removable under CAFA as a class action because it was not "similar" enough to a true class action**. The Attorney General is not a member of the class whose claims would be typical of class members' claims; the relevant West Virginia laws do not contain numerosity or commonality requirements; and the state's laws authorize actions without providing notice to the represented consumers, which would be essential in a class action seeking monetary damages. Although the panel's ruling came over a strong dissent, a petition for en banc review was denied. A petition for a writ of certiorari is pending in the Supreme Court.

Significantly, the Fourth Circuit's ruling departs from other decisions, including a decision from the Eastern District of Pennsylvania, *West Virginia ex rel. McGraw v. Comcast Corp.* There, the district court reached the opposite conclusion on CAFA removability in a suit by the West Virginia Attorney General alleging that a cable company's requirement that its subscribers rent cable boxes only from it violated the state's antitrust and consumer protection laws. In ruling, the district court relied heavily on a 2008 Fifth Circuit case, *Louisiana ex rel. Caldwell v. Allstate Insurance Co.* The Caldwell court similarly held that parens patriae actions may be removed under CAFA, noting that CAFA was enacted to prevent "jurisdictional gamesmanship."

Arbitration Roundup

BY LANDON CLAYMAN

In a case of first impression for the court, the U.S. Eleventh Circuit Court of Appeals ruled that the filing of an amended complaint may revive a defendant's right to compel arbitration, notwithstanding its previous waiver of that right. In *Krinsk v. SunTrust Banks, Inc.*, the plaintiff filed a putative class action alleging various common law and federal statutory claims relating to the bank's decision to suspend her access to a home-equity line of credit. Although the loan documents contained an arbitration provision, SunTrust participated in the litigation for nine months without asserting – and thus waiving – its right to arbitrate. When the plaintiff filed an amended complaint with allegations that greatly enlarged the potential size of the putative class, the bank asserted its right to arbitrate; the district court, however, ruled the bank had waived the right. The Eleventh Circuit reversed, ruling that when an amended complaint unexpectedly changes the scope or theory of a plaintiff's claims, a defendant may be permitted to rescind its earlier waiver and revive its right to compel arbitration.

This "reasoned award" business just has me flummoxed.

By agreement, or by invocation of a AAA rule, parties often require that the arbitrator[s] provide a "reasoned award," anticipating that the rationale for the award will be provided. In *Cat Charter, LLC v. Schurtenberger*, the Eleventh Circuit reversed a district court's order vacating an arbitration award because it failed to provide a "satisfactorily reasoned award." The court of appeals explained that a "reasoned award" fell somewhere along a spectrum between a "standard award," which simply announces a result, and "findings of fact and conclusions of law," which require the most detailed explanation of the arbitrator[s]' reasons. The court's description of a "reasoned award" – one provided with mention of justifying expressions or statements – set what some might consider a low bar. In this light, **parties seeking a more detailed explanation of an arbitration award should eschew a "reasoned award" and by their arbitration agreement require that the award provide "findings of fact and conclusions of law,"** which the Eleventh Circuit described as "a relatively exacting standard familiar to the federal courts."

Mark Your Calendar

On December 13, 2011, **Elizabeth Bohn**, partner in the Miami office, will be presenting "Bankruptcy Exemptions, Discharge and Objections to Dischargeability." The presentation is part of the National Business Institute's Continuing Legal Education for Professionals series. For more information visit *www.nbi-sems.com*.

Sweeping Changes to U.S. Patent Laws

BY DONALD K. GHOSTLAW

The Leahy-Smith America Invents Act (the AIA), signed into law by President Obama on September 26, 2011, is the most comprehensive change to the U.S. patent laws in over 50 years. The most significant changes include:

Time to re-examine and re-evaluate IP programs and strategies?

Filing

- A change in the United States patent system from first-to-invent to first-inventor-to-file (FITF) to determine priority of inventorship. FITF will apply in general with respect to patent applications for new claims filed on or after March 16, 2013.
- A grace period permitting an inventor to file a patent application up to one year after initial disclosure of the invention by the inventor (or by another who obtained the subject matter of the invention from the inventor) and still claim FITF status.
- A new class of "micro entities" entitled to deeply discounted fees, and a prioritized examination option available for an additional fee.

Review

- During the time period beginning on September 26, 2012 and for eight years following, defendants who are sued for, or charged with, infringement of certain business method patents that relate to a financial product or service may, subject to certain restrictions, request that the patent be reviewed by the U.S. Patent and Trademark Office (USPTO).
- A post-grant review procedure permitting third parties an opportunity to request review of an issued patent by the USPTO on any ground within nine months of issue.
- Procedures permitting third parties (non-applicants) to submit prior art to the USPTO examiner within certain time restrictions for inclusion in the patent application record, and for consideration by the patent examiner.

Litigation Defense

- A "prior commercial use" infringement defense formerly applicable in limited cases is now available to most prior users and in connection with all technologies, for defendants who were first to commercialize an invention but did not file a patent application, provided that such prior use existed for at least one year before the effective filing date of plaintiff's patent application or one year before the date that the invention was first disclosed by plaintiff (or by another who obtained the subject matter of the invention from the plaintiff).

Based on the AIA, **all entities should consider re-evaluating their intellectual property programs and strategies**. For example, in light of the pre-filing disclosure provisions of the AIA, your company may decide to update its non-disclosure agreement forms in connection with the disclosure of patentable inventions.

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