EXPECT FOCUS®

LEGAL ISSUES & DEVELOPMENTS FROM JORDEN BURT LLP

VOLUME II SPRING 2013

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- LIMITS ON THE ECONOMIC LOSS RULE
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Half Empty/Half Full

Market Conditions Often Depend On Perspective

JORDEN BURT LLP

25TH ANNIVERSARY

EXPECTFOCUS® VOL. II SPRING 2013

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IN THE SPOTLIGHT

Private Mortgage Insurance: The Other Lender-Placed Coverage

BY JOHN PITBLADO & BERT HELFAND

Lender-placed (or force-placed) flood and hazard insurance is a big story—the subject of settlements with state regulators, new Consumer Financial Protection Board (CFPB) regulations and dozens of putative class actions. Lenders are required to buy the insurance for certain borrowers who fail to maintain it. Some banks use their own licensed affiliates to do so. Critics complain that commissions insurers pay those affiliates are "kickbacks" that inflate the price. In court, bank defendants have argued that plaintiffs' common law claims are both pre-empted by federal banking laws and barred by the filed rate doctrine—which protects insurers from suits for charging rates that have been approved by a government authority. Some courts rejected the filed rate defense at the motion-to-dismiss stage, but the tide may be turning: in *Kunzelmann v. Wells Fargo Bank, N.A.*, a Florida federal court recently denied class certification on the ground that the doctrine "must be addressed." (More information about these developments is available at *www.PropertyCasualtyFocus.com*.)

A parallel story involves private mortgage insurance (PMI), which low-equity homeowners typically must obtain to protect the lender against the risk of default, and which the lender generally places on the borrower's behalf. In a practice that was especially prevalent during the last housing boom, certain insurers agree to cede a portion of the premium they receive on policies placed by a given bank to a reinsurer that is also a subsidiary of that bank. Critics claim the reinsurers bear little or no actual risk, and so that the arrangement is a "kickback" that violates the Real Estate Settlement Procedures Act (RESPA). In April, the CFPB settled claims against four insurers who agreed (without admitting fault) to pay penalties totaling more than $15 million. The practice has also generated a small but significant number of class actions.

The filed rate defense has generally failed in these cases, because of RESPA's express prohibitions against "kickbacks." In *Alston v. Countrywide Fin. Corp.*, for instance, **the Third Circuit Court of Appeals held that the defense was unavailable, because RESPA creates a claim for any transaction that involves improper consideration, even if the plaintiff has not been "overcharged."** The Ninth Circuit has read RESPA much the same way (in a slightly different context), and in *Munoz v. PHH Corp.*, a California federal district court recently concluded that, "[a]s circumstances currently stand, there is no basis to permit" a filed rate defense.

The latest decisions focus, instead, on RESPA's one-year statute of limitations. In *McCarn v. HSBC USA, Inc.*, plaintiffs argued that the statute had been equitably tolled, because the alleged "scheme" was "self-concealing." The California federal court, finding that plaintiffs had "fail[ed] to allege misrepresentations beyond the actual basis for the lawsuit," dismissed the complaint. The Third Circuit, however, generally advises district courts not to rule on equitable tolling at the pleading stage. In *Riddle v. Bank of America Corp.*, the Eastern District of Pennsylvana reached the opposite conclusion: it denied a motion to dismiss, finding that an allegation that mortgage documents "misleadingly" made the reinsurance look legitimate should be "deemed separate and apart from the actual RESPA violation."

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LIFE INSURANCE

NAIC Life and Annuities (A) Committee's Final Four Round-Up

BY ANN BLACK & KRISTIN SHEPARD

During the 2013 NAIC Spring National Meeting, NAIC Life and Annuities (A) Committee (the Committee) heard reports from its four working groups – Annuity Disclosure (A) Working Group (the Annuity Disclosure WG), Contingent Deferred Annuity (A) Working Group (the CDA WG), ERISA Retirement Income (A) Working Group (the ERISA WG), and Viatical Settlements (A) Working Group (the Viatical WG) – as well as from the Life Actuarial (A) Task Force.

While some industry members hoped to score three, the Annuity Disclosure WG completed work on two versions of the Buyer's Guide:

- The NAIC's Buyer's Guide for Deferred Annuities – describing fixed, fixed indexed, and variable annuities.
- The NAIC Buyer's Guide for Fixed Annuities – describing fixed and fixed indexed annuities.

The Committee adopted the two versions of the Buyer's Guide and granted the Annuity Disclosure WG overtime to work on the development of an electronic version of the Buyer's Guide as well as consideration of a Buyer's Guide for Variable Annuities.

The CDA WG completed its report and recommendations on contingent deferred annuities (CDAs). In its report, the CDA WG concluded that CDAs were on the line in that they have features of variable annuities – the value of the benefits are determined in part by market performance – and of fixed annuities – once withdrawals begin, the benefit is fixed and periodic upon annuitization. Rather than classifying as one or the other, the CDA WG defined CDAs as "an annuity contract that establishes a life insurer's obligation to make periodic payments for the annuitant's lifetime at the time designated investments, which are not owned or held by the insurer, are depleted to a contractually-defined amount due to contractually-permitted withdrawals, market performance, fees and/or other charges." The CDA WG also sought to pass to other working groups and task forces within the NAIC:

- The review of the adequacy of existing annuity solvency laws and regulations as applied to CDAs to consider if changes are necessary.
- The review and modification of the Life and Health Insurance Guaranty Association Model Act, Annuity Disclosure Model Regulation, Suitability in Annuity Transactions Model Regulation, Advertisement of Life and Annuities Model Regulation, Standard Nonforfeiture Law of Individual Deferred Annuities, as well as other NAIC models to make necessary changes to clarify their applicability to CDAs as outlined in the report.
- Development of a template/checklist of questions states could use to facilitate review of a company's risk management program at the time of policy form filing.

The Committee adopted the CDA WG report and agreed to seek assists from other working groups and task forces.

The ERISA WG continued receiving information from the industry about the use of annuities within ERISA and tax qualified plans. In addition, the National Organization of Life & Health Guarantee Association discussed its review of guaranty fund coverage for annuities within ERISA and tax qualified plans. The ERISA WG is considering this information in order to develop its game plan for the next steps.

The Viatical WG finished its work on a consumer information brochure and changes to certain reporting requirements. In adopting the Viatical WG's revisions to the Viatical Settlements Model Regulation, the Committee disbanded the Viatical WG.

Fed Floats Fees for Financial Firms

BY TOM LAUERMAN

The Federal Reserve Board is seeking comments by June 15, 2013 on proposed fees that systemically risky firms would pay to defray the Board's cost of regulating them.

These firms include (a) bank holding companies with assets of more than $50 billion and (b) any non-bank financial companies that the Financial Stability Oversight Council determines present so much risk to the U.S. financial system that they should be subject to special regulation by the Board. The non-bank financial companies that the Council may designate as systemically risky include some insurance holding companies and perhaps even some investment companies.

The Dodd-Frank Act requires the systemically risky firms to pay the Board's cost of regulating them, which the Board estimates totaled $440 million last year. In general, the Board's proposed fees would allocate these costs to all of the systemically risky firms in proportion to their respective consolidated assets.

This proposed methodology for allocating regulatory costs is likely to produce at best only a very rough kind of justice – particularly in the case of any insurance companies and other non-bank firms that are designated as systemically risky. Accordingly, the Board's proposal states that, as the Council begins to make such designations, the Board will review the matter and make any required revisions to its method of assessing the fees for non-bank firms.

Financial Regulation Modernization Update: More Eyes on Captives?

BY ROLAND GOSS

The last issue of *Expect Focus* featured an article describing an NAIC subgroup that was conducting an inquiry into the operation of certain captive insurance companies. The work of that group has progressed to the exposure of a revised draft of a white paper for public comment. One significant remaining inquiry is whether some life insurance companies are improperly using captives to evade certain statutory reserve accounting rules. Some issues within the subgroup's discussions remain subject to diverse opinions by subgroup members, and have been identified for further investigation. There is now another group studying captives – a task force established by the Federal Insurance Office (FIO). Most of the activities of the FIO to date have focused on international issues, and it is unclear why this rather narrow domestic issue has been identified for study by an FIO task force, particularly in light of the NAIC's ongoing work.

On the international scene, it had been anticipated that the Financial Stability Board, in consultation with the International Association of Insurance Supervisors, would name systemically important insurers in April. That announcement now has been delayed, perhaps to June or July. The reason for the delay is uncertain, but some have suggested that if the regulators identify certain products as presenting systemic risk, **some insurance companies may alter their business model either to cease offering such products or to offer them in a manner that can isolate the company from the risks and potential additional capital requirements related to such products.**

Finally, it is now anticipated that the FIO's report on the status of insurance regulation in the United States, which was required by the Dodd-Frank Act to be issued in January 2012, will be issued in July of this year. It is not yet clear whether the separate report on the reinsurance industry, which was supposed to be issued in September 2012, will be issued at the same time.

Diverse Policyowner Preferences Sink Cost of Insurance Class Certification

BY JASON BROST

In a year of noteworthy developments in COI litigation, the denial of class certification in *Thao v. Midland National Life Insurance* revealed that common answers to common questions did not always satisfy Rule 23.

In *Thao*, plaintiff sought certification of a multi-state class of purchasers of Midland's universal life insurance policies and identified as a common question whether Midland violated the terms of these policies by considering factors unrelated to mortality expectations in setting cost of insurance rates. **The court found that while there was likely a single answer to this question, class certification was inappropriate because some class members would prefer the use of factors other than mortality expectations in setting COI rates.**

The court explained that using only mortality expectations, premiums would generally be lower in the early years of a policy and higher in later years, while the formula that Midland used would yield the opposite result. Because some class members would prefer to pay higher rates in earlier years in exchange for lower rates later on, the court found that what the named plaintiff saw as a disadvantage of Midland's interpretation of the contract would be advantageous to many class members, leaving them without a common grievance that could be remedied through class treatment.

Discovery Rule Prevents Dismissal In Spite of Contract Language

BY TODD WILLIS

Plaintiffs in *Rasgaitis v. Waterstone Financial Group, Inc.* claimed that the investment advisory firm and its investment advisers "intentionally and fraudulently" "advised the plaintiffs to mortgage near all of the equity in their home and invest in 'an investment plan'" allegedly promising "hundreds of thousands of dollars in benefits." The defendants allegedly placed plaintiffs' funds, through the investment plan, in life insurance policies and indexed annuities but failed to explain "the associated fees, expenses and surrender charges." Plaintiffs alleged numerous fraud-based counts against all defendants, and a negligence and negligent supervision count against the investment firm.

The plaintiffs argued on appeal that the claims were not barred by a two-year Illinois statute of limitations, asserting that other limitation periods applied. The appellate court, however, did not reach this question. Instead, it found that "under the discovery rule the plaintiffs' complaint was timely filed." The limitations period began running when plaintiffs "sought other professional advice and learned that the 'investment plan' could never generate the returns represented."

In so holding, the *Rasgaitis* court disregarded the defendants' argument that the "life insurance policies and annuity contracts contained language putting the plaintiffs on notice of the investment risks." The defendants pointed to surrender charge disclosures and statements that the values shown were not "guarantees, promises or warranties." The *Rasgaitis* court found the disclosures insufficient, because the cautionary language was not detailed and specific, and "despite having been warned by FINRA," the defendants "failed to disclose the complex nature of equity-indexed annuities and the known risks of funding investments through a full residential mortgage."

Limitations period began running when plaintiffs "sought other professional advice and learned [of the alleged misrepresentations]."

The *Rasgaitis* court, however, upheld the dismissal of the negligence and negligent supervision claims – because plaintiffs only sought recovery of monetary losses, these claims were barred by the economic loss rule.

One STOLI Action's Jurisdictional Twist

BY KYLE WHITEHEAD

For jurisdictional purposes, role matters. In *Nationwide Life and Annuity Insurance Co. v. Golden*, a recent STOLI diversity action in which Nationwide alleged that a $4.5 million life insurance policy issued by it was void *ab initio* because of material misrepresentations in the application, the Southern District of Ohio expounded upon the question of whether an incidental role in an alleged STOLI scheme can constitute "purposeful availment" for purposes of *in personam* jurisdiction. Distinguishing between those actors initiating or originating contact with a forum state and those actors merely playing secondary or ancillary roles, a magistrate judge ruled that the court could invoke personal jurisdiction over the producing agent and the original policy owner, but it could not invoke personal jurisdiction over the accountant involved or the subsequent policy owner.

Focusing on Ohio's long-arm statute, **the court found that, because the agent and original owner, both from California, knowingly sent false application documents to Nationwide in Ohio, they should have reasonably expected that Nationwide would be injured in Ohio.** Additionally, they had minimum contacts with Ohio because they had purposely availed themselves of the privilege of transacting business in the state.

The court then determined that the accountant and subsequent owner, both also from California, did *not* have minimum contacts with Ohio. The accountant had merely verified the insured's income and net worth, as already listed in the application and, although the subsequent owner: (1) signed change-of-ownership and -beneficiary forms, (2) submitted premium checks, and (3) submitted a death claim, the court found that Nationwide's claim had not arisen from those actions, as original contractual terms had mandated them.

Notwithstanding the lack of personal jurisdiction over the accountant and subsequent policy owner, the judge determined that it was in the interest of justice to recommend transfer of the entire action to California, where most, if not all, of the operative facts alleged had occurred. Regardless, *Golden* makes clear that merely incidental roles or communications in an insurance transaction may not establish minimum contacts, and that performance of contractual terms under an insurance policy does not, by itself, establish minimum contacts.

Class Action Update: Rulings Involving Life Insurers

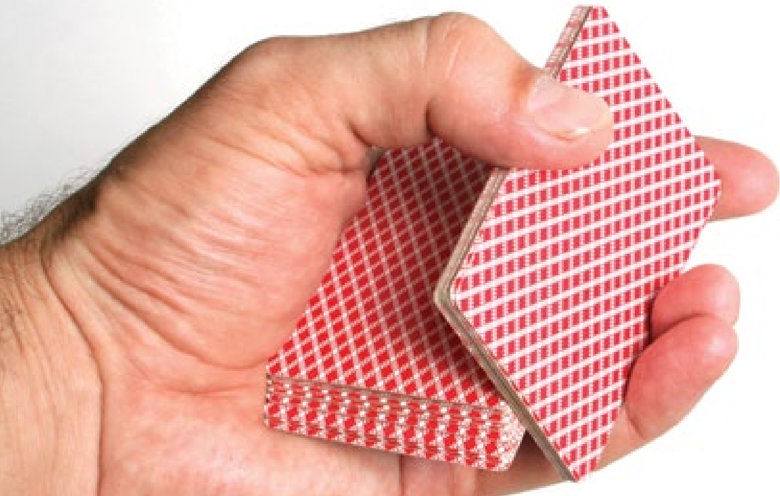
BY ABIGAIL KORTZ

Federal courts in New Jersey and California recently denied, in whole or in part, motions for class certification in three different actions involving life insurers. In *Bouder v. Prudential Financial*, Prudential insurance agents brought suit in New Jersey against Prudential under the Fair Labor Standards Act (FLSA) and the labor laws of eleven different states alleging violations related to overtime compensation. Plaintiffs sought certification under Rule 23(b)(3) of eleven state law classes and seven subclasses. In its analysis, the court emphasized its concern that Prudential might raise the defense that some of its agents are independent contractors, which would require an individualized, multi-factor analysis of the independent contractor status of a significant cross-section of each proposed subclass. The complexity of the individual analysis, coupled with the numerosity of proposed subclasses, prompted the court to deny plaintiffs' motion for class certification due to foreseeable difficulties in the management of the class action.

In *Clark v. Prudential Insurance Co. of America*, wherein plaintiffs alleged that Prudential failed to disclose that Prudential stopped selling a particular health policy and misrepresented its basis for raising premium rates, the New Jersey district court likewise denied class certification for lack of typicality and adequacy of representation and because individual determinations of fact and law predominated. The court found that the plaintiffs' claims were not typical of the class because the named plaintiffs represented only the 1% of proposed class members who held their policies for more than 18 years after the first rate increase. The court also found that individual inquiries predominated because: (1) there were many reasons, other than the rate increase, that might have prompted putative class members to drop their policies, which created varying degrees of materiality and reliance on the misrepresentations; (2) Prudential did not communicate the closure of the book of business or rate increases with policyholders in a uniform fashion; and (3) plaintiffs could not establish a class-wide approach to equitable relief.

A California district court took the more limited approach of denying class certification as to only one of plaintiffs' six theories of recovery in *Walker v. Life Insurance Co. of the Southwest*. Plaintiffs alleged that, in the marketing and sale of indexed universal life insurance policies, defendant failed to disclose certain fees, characteristics of the policies, the method of crediting interest, and the adverse effect that market volatility could have on policy values, all of which increased the risk of policy lapse. The court concluded that plaintiffs' claims based on the assertion that defendant's illustrations depicted benefits in the eleventh year of the policy (i.e. reduced fees) that no policy owner had actually received were not amenable to class treatment because the misrepresentation was not actionable absent a lack of intent to make good on the representations. On all other theories, the court found that the plaintiffs satisfied the class certification requirements of Rule 23(a) and (b)(3).

The complexity of the individual analysis, coupled with the numerosity of proposed subclasses, prompted the court to deny plaintiffs' motion for class certification due to foreseeable difficulties in the management of the class action.



Appropriate Equitable Relief Cannot Trump Plan Terms

BY JON STERLING & W. GLENN MERTEN

The United States Supreme Court recently resolved a circuit split in *US Airways, Inc. v. McCutchen, et al.*, finding that "appropriate equitable relief" under ERISA does not permit a court to rewrite the terms of an ERISA plan.

In connection with an auto accident, the US Airways' health benefits plan paid $66,866 in medical expenses for James McCutchen, a participant in the plan. In a lawsuit against the other driver, McCutchen recovered $110,000, leaving him with $66,000 after paying a 40% contingency fee to his attorneys. Pursuant to the terms of the plan, US Airways demanded McCutchen reimburse it for the entire $66,866 it had paid to cover his medical expenses. After McCutchen refused, US Airways sued under ERISA section 502(a)(3) seeking "appropriate equitable relief" to enforce the plan's reimbursement provision. The district court granted summary judgment to US Airways, finding that the plan unambiguously provided for full reimbursement of medical expenses paid.

The Third Circuit Court of Appeals reversed, holding that the doctrine of unjust enrichment should reduce the plan's recovery, and that the district court should determine some amount less than full reimbursement that constitutes "appropriate equitable relief." This holding further exacerbated a pre-existing circuit split, with the Third and Ninth Circuits holding that a trial court has equitable power under ERISA to rewrite plan terms, while the Fifth, Seventh, Eighth, Eleventh, and DC Circuits previously had held that express, unambiguous plan terms control over equitable principles.

Based on its opinion in *Sereboff v. Mid Atlantic Medical Services* (2006), the Supreme Court reversed the Third Circuit, finding that equitable defenses cannot override the plain terms of an ERISA plan. In so holding, **the Court rejected the government's claim that "the common-fund rule has a special capacity to trump a conflicting contract."** Nevertheless, in a portion of the opinion joined by a bare majority the Court found that the US Airways plan was silent on the allocation of attorney's fees in connection with a third-party recovery, and therefore the trial court should look to "background legal rules," including the common fund doctrine, to ascertain the parties' intent.

Court Rejects Certification In Block Closure Case

BY W. GLENN MERTEN

In a lengthy decision, a federal court in New Jersey denied class certification and granted partial summary judgment to the defendant in *Clark v. The Prudential Insurance Company of North America*, a four year old, hotly litigated case. In 1981, Prudential closed the block on its Coordinated Health Insurance Program, or CHIP. After the block closed, CHIP premiums began to increase. The plaintiffs alleged that Prudential misrepresented the reasons for premium increases, claiming that the block closure and a purported "death spiral" were the actual causes of the increases. After numerous amendments, plaintiffs asserted claims on behalf of approximately 17,000 CHIP policyholders across four states who paid an increased CHIP premium after March 1, 1982.

In denying class certification, **the court rejected the plaintiff's contention that the materiality of alleged misrepresentations could be could be determined using an "objective" standard, finding instead that "individualized consideration" was required.** In addition, the presence and impact of oral communications to CHIP policyholders, the plaintiffs' failure to provide a common formula or methodology for determining damages, and concerns about the typicality and adequacy of the named plaintiffs influenced the decision to deny certification.

The court also granted summary judgment to Prudential on statute of limitations grounds as to two plaintiffs, but denied summary judgment on similar grounds as to two other plaintiffs. The plaintiffs subsequently moved for reconsideration of the denial of class certification and partial summary judgment, and requested that that the court alter or amend its class certification decision: (1) to narrow the class definition and (2) bifurcate liability and damages to certify a class solely for purposes of liability. The court denied all of the plaintiffs' motions.

Multiple Chinese Drywall Claims Against Importer Constitute a Single "Occurrence"

BY JOHN PITBLADO

Devon International, an importer, was insured by Cincinnati Insurance Company under two commercial general liability policies, covering consecutive one-year periods from November 2008 to November 2010. Each policy covered property damage caused by an "occurrence" that "occurred" during the policy period.

In 2006, Devon had purchased drywall from a Chinese manufacturer to fill orders from a distributor and several individual customers. All the drywall came by way of a single order and a single shipment. In 2009, the distributor asked Devon to defend it in a claim alleging defects in the drywall. Devon was then named in a "multitude" of lawsuits, in "various" jurisdictions, alleging that sulfur emitted by the drywall had damaged real and personal property. Devon looked to Cincinnati for coverage, but the insurer contended that the lawsuits all arose out of a single "occurrence" that preceded the policy periods, and it brought a declaratory judgment action in Pennsylvania federal court.

The court in *Cincinnati Ins. Co. v. Devon Intern., Inc.* considered three different approaches to determining the number of occurrences: the majority "cause" approach, under which the event that causes the injury constitutes the "occurrence"; the minority "effects" approach, and a third approach that examines "the events triggering liability."

The court determined that Pennsylvania would follow the majority approach; because Devon's single purchase and shipment of defective drywall was the cause of injury in all the lawsuits, the court held that there had been only one occurrence – Devon's allegedly poor choice of a drywall supplier in 2006.

However, in looking at *when* this single occurrence occurred, the court cited Pennsylvania precedent holding that **"an occurrence happens when the injurious effects of the negligent act first manifest themselves."** Because the parties had stipulated that the effects of the drywall alleged in the suits manifested during the first policy period, the court held that there was one covered occurrence, and that it was covered under the first policy. Devon's claim was therefore subject to the limit for a single occurrence, but it *was* entitled to coverage.

Scribner, Hall & Thompson, LLP

Market Fluctuations Rule Can Be Used to Extend Deemed Diversification for Liquidations of Separate Accounts

BY JANEL FRANK

In PLR 201309011 (Nov. 29, 2012), the IRS concluded that certain assets held in segregated accounts will not be deemed to fail the diversification requirements of I.R.C. § 817(h) if the failure is a result of distributions pursuant to a plan of liquidation. The taxpayer issued variable life insurance contracts that permitted contractholders to allocate premiums between several investment options. The amounts invested were held in segregated asset accounts, which invested in various assets through corresponding funds. As a result of the recent economic downturn, the funds suffered severe losses in certain investments, which then instituted redemption restrictions. The taxpayer thereafter proposed to liquidate the funds by distributing cash (as it was received) to the contractholders on a pro-rata basis. Although no new assets would be purchased, the taxpayer was concerned that each cash distribution would reduce its overall holdings, such that the relative value of the funds' remaining assets would violate the diversification requirements of I.R.C. § 817(h). The IRS concluded there would be no diversification failure based on Treas. Reg. § 1.817-5(d), which provides that a segregated asset account that satisfies the diversification requirements at the end of a calendar quarter will continue to be treated as diversified unless the failure results from the acquisition of an asset.

Note, the ruling seemingly does not consider Treas. Reg. § 1.817-5(c)(3), which provides for up to a two-year deemed period of diversification for segregated asset accounts that adopt a plan of liquidation. However, this ruling effectively extends the allowed liquidation period for an indeterminate time as long as the segregated asset account does not acquire new assets (which would be unusual under a plan of liquidation in any case).

While Florida Limits the Economic Loss Rule, Potential Liability Keeps Growing

BY BERT HELFAND

In March 2013, in what a dissenting opinion called a "dramatic unsettling of Florida law," the Supreme Court of Florida abolished the "economic loss rule" for all cases not based on product liability. The rule prohibited tort actions that sought to recover purely economic damages from a party in contractual privity with the plaintiff. The sweeping nature of the court's ruling overshadowed the fact that it was delivered in response to a certified question about whether an insurance broker provides "professional services," such that it might face liability for what amounts to a claim for malpractice. But that aspect puts the decision in line with other recent cases that show increasing solicitude for even sophisticated consumers of insurance products, and a corresponding increase in the exposure of those who sell them.

In *Tiara Condominium Assoc. v. Marsh & McLennan Companies*, the plaintiff's condominium suffered severe damage in two hurricanes. After its broker advised that its property policy had a $50 million limit per occurrence, the plaintiff spent more than $100 million on remediation. In fact, the policy provided $50 million of aggregate coverage, and the plaintiff brought a negligence claim against its broker in federal court to recover the unreimbursed portion of its expenses.

That claim would ordinarily have been precluded by the economic loss rule, under which a tort action is barred if the defendant "has not committed a breach of duty apart from a breach of contract." But Florida courts recognized an exception for cases alleging neglect in professional services. For that reason, the Court of Appeals for the Eleventh Circuit certified a question about whether an insurance broker provides "professional service" within the meaning of the exception.

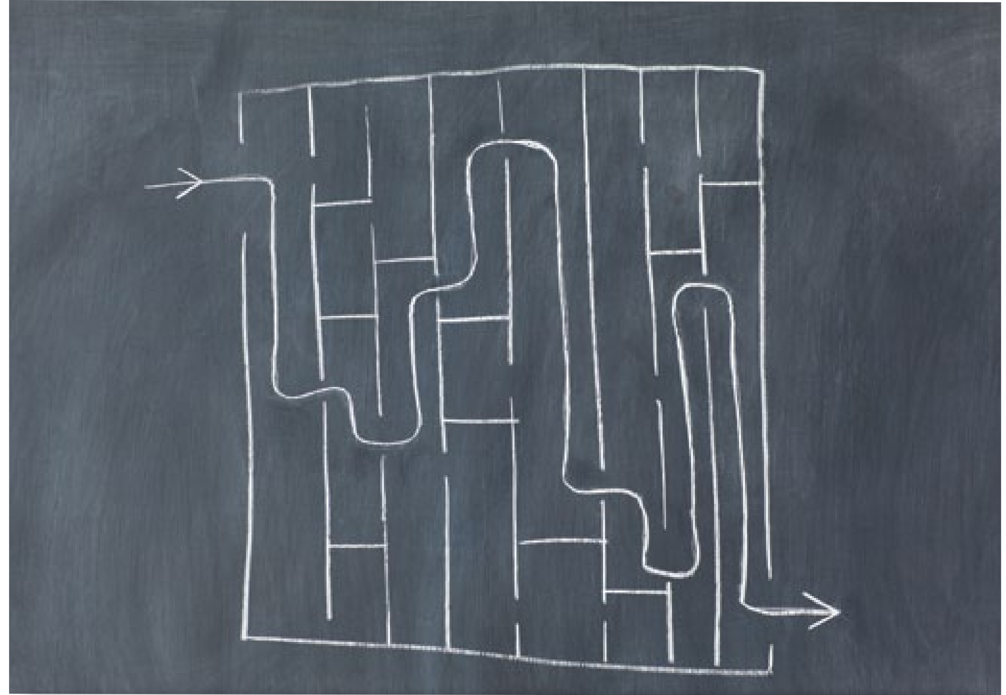
The Florida Supreme Court did not answer that narrow question, because it chose to eliminate the rule entirely, except in product liability cases. But that only makes it more significant that one of the two dissenters wrote, "[t]he services of Marsh & McLennan … certainly appear professional to me." **Even if the court had preserved the economic loss rule, it appears that a majority would still have declined to apply the rule in this case.**

Expect Focus recently reported [Winter 2013] that New York's highest court similarly ruled last November, in *American Building Supply v. Petrocelli Group*, that a corporate insured "should have the right to look to the expertise of its broker," even where the insured could have avoided injury by reading its own policy. In February 2013, in *Ambroselli v. C.S. Burrall & Son*, the U.S. District Court for the Western District of New York found there are circumstances in which **an insurer's agent may have an affirmative duty to advise an insured to buy additional coverage**—a duty New York's courts have not yet recognized. Thus, while the majority in *Tiara* did not focus on the insurance issues, that might turn out to be where the case's true significance lies.

Deja Vu: Defendant's Time To Remove Bad Faith Lawsuit Expired Before It Was Sued

BY JOHN HERRINGTON

In a procedural riddle worthy of Kafka (or perhaps H.G. Wells), the United States District Court for the Southern District of Florida recently held that a defendant's removal of a coverage action to federal court became untimely two years before the defendant had been sued.



Florida Federal Court maps the route back to federal court.

The plaintiff in *Hoggins v. Mid-Continent Cas. Co.* was electrocuted on a construction project. In April 2009, he filed a negligence action in state court against the project's general contractor and certain other defendants. The contractor had a liability policy with Mid-Continent Casualty, but Mid-Continent determined that an exclusion applied, and it refused to provide a defense. Three years later, the plaintiff dismissed his claims against all of the defendants other than the contractor. He executed a stipulation with the remaining defendant (commonly known as a *Coblenz* agreement), in which the contractor confessed judgment, the plaintiff agreed not to execute on the judgment, and the contractor assigned all of its rights against Mid-Continent.

Under Florida law, a creditor may conduct post-judgment proceedings, or "proceedings supplementary," to effectuate the execution of an unsatisfied judgment. In those proceedings, the court may order any property that is "due to the judgment debtor to be applied toward the satisfaction of the judgment debt." In September 2012, as part of such proceedings, plaintiff was granted leave to file a supplemental complaint for breach of contract against Mid-Continent. On October 19, 2012 Mid-Continent removed the case, based on diversity of citizenship. Plaintiff then moved to remand under the former 28 U.S.C. §1446(b) (now § 1446(c)), which provided that a case could not be removed on diversity grounds "more than one year after the commencement of the action."

> Florida law deems civil actions to commence on the date the original complaint is filed, and, therefore, the addition of a new claim does not reset the one-year limitation period

Mid-Continent opposed the motion, citing a provision of the removal statute (which has since been eliminated) that permitted removal of an otherwise nonremovable case, if that case had been joined to a "separate and independent" claim that was subject to federal jurisdiction. While Mid-Continent relied on four decisions from the Middle District of Florida (and one from the Northern District of Ohio) which applied that rule by analogy to post-judgment bad faith claims against insurers, the court noted a *Southern* District decision, *Potts v. Harvey*, holding that Florida law deems civil actions to commence on the date the original complaint is filed—and, therefore, that the addition of a new claim does not reset the one-year limitation period. Finding *Potts* persuasive, the *Hoggins* court remanded the case.

The court then added a touch of Joseph Heller: In a footnote, it reasoned that Mid-Continent could file a motion in state court to dismiss or sever the breach of contract claim from the underlying action, and, when that motion was denied, it could petition a Florida appellate court for a writ of *certiorari*, on the ground that denial of the motion had deprived it of its right to remove the case.

Staking Claims: Unclaimed Property Update

BY ANTHONY CICCHETTI

Litigation developments in West Virginia and Kentucky on April 1 put an exclamation point on the abundant activity occurring in the first quarter of 2013 on the unclaimed property front. Below is a summary of first quarter developments potentially affecting insurance companies that issue life insurance, annuities, and retained asset accounts.

Litigation

West Virginia's Treasurer has sued 69 life insurance companies, alleging that they breached an implied good faith obligation to search the U.S. Social Security Administration's Death Master File (DMF) to identify deceased insureds and attendant obligations to pay death benefits, leading to noncompliance with escheat requirements under the state's unclaimed property laws. The defendant companies recently filed their responses to the complaints. Most companies have filed a motion to dismiss, with 39 companies filing a "common" brief in support of their motions on April 1, 2013.

Kentucky's enactment of an Unclaimed Life Insurance Benefits Act was challenged last year in *United Insurance Company of America et al. v. Commonwealth of Kentucky*. Whether the Act could lawfully apply to policies issued prior to the Act's effective date is the central issue in this litigation. Among other challenges, the plaintiff insurance companies have asserted that the Act violates the Contracts Clause of the U.S. Constitution and Kentucky's Constitution. On April 1, 2013, the court issued an opinion and order granting summary judgment to the State of Kentucky and denying the companies' motion for summary judgment.

Ohio's Court of Appeals in *Andrews v. Nationwide Mutual Insurance Company* (a putative class action) last year affirmed dismissal of the complaint, holding that defendants did not have a duty to search the DMF for potentially deceased insureds. The court reasoned that imposing such an obligation would be contrary to the terms of the insurance policies, which require beneficiaries to submit a claim and provide proof of death. The court concluded that the implied covenant of good faith and fair dealing cannot create rights or duties not otherwise provided for in the contract. After unsuccessfully seeking *en banc* review, plaintiffs appealed to the Supreme Court of Ohio in January 2013.

Briefs have been filed on defendants' pending motion to dismiss in *Feingold v. John Hancock Life Insurance Company (USA)*, a putative class action in the U.S. District Court for the **District of Massachusetts**. The suit alleges generally that defendants' failure to search the DMF constituted a pattern and practice of avoiding payment of life insurance benefits and untimely escheating of unclaimed benefits. The court has denied as "premature" a motion for class certification.

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Legislative and Regulatory

Companies continue to report being the subject of audits conducted on behalf of state unclaimed property regulators and state insurance departments with respect to compliance with unclaimed property laws and insurance claims payment practices. At the same time, legislators and regulators have been working on pertinent laws and regulations.

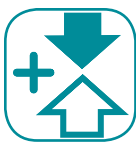
In March 2013, **Montana's** legislature passed and sent to the Governor for signature an Unclaimed Life Insurance Benefits Act, which requires, among other things, that companies search the DMF, or comparable record, at least semiannually. Similar steps were taken earlier this year in **Nevada**, **Rhode Island**, **North Dakota**, **Vermont**, and **New Mexico**. In February, a bill was introduced in **Alabama's** legislature to establish DMF search requirements for life insurance policies, annuity contracts, and retained asset accounts issued or entered into on or after January 1, 2016.

Effective February 6, 2013, **New York** re-adopted, with amendments, emergency Rules 11 NYCRR 226.0 - 226.6 concerning payment of unclaimed life insurance benefits. Legislation was enacted in March that modifies and purportedly clarifies the statutory procedures life insurers must follow under New York's Section 3213-a (Unclaimed Benefits), which was signed into law on December 17, 2012, and will take effect on June 15, 2013.

In March, a bill was introduced in the **Minnesota** legislature to enact and modify the Uniform Unclaimed Property Act of 1995. **Mississippi** introduced a bill to enact the 1995 Act in January.

Noting "many technological developments in recent years that are not addressed in the current Uniform Act," the Executive Committee of the **Uniform Law Commission** (ULC) authorized the appointment of a new Study Committee on Revision of or Amendments to the Uniform Unclaimed Property Act. This Committee "will consider the need for and feasibility of drafting and enacting a revision of or amendments to the Uniform Unclaimed Property Act."

Some states are revising laws relating to their holding and use of escheated funds. **Georgia's** H.B. 359 proposes to change the law by requiring that all unclaimed property funds be placed into the general fund. The law currently requires the commissioner of revenue to retain - in a separate trust fund - a sum sufficient to make prompt payment to persons claiming an interest in unclaimed property. **Oklahoma** Senate Bill 1108 seeks to dedicate $10 million of the state's unclaimed property fund to the Oklahoma Teachers' Cost of Living Benefits Adjustment Fund. **South Dakota** Senate Bill 235, signed by the Governor in late March, calls for the state treasurer to transfer into the "building South Dakota fund" 25% of the unclaimed property deposited in the general fund pursuant to the state's unclaimed property act in 2015, and 50% in 2016 and each year thereafter.



Pushing Boundaries: Not Just for Kids

BY MARILYN SPONZO

In a demonstration of jurisdictional scope-creep, FINRA, as of February 23, amended Rule 8210 to require broker-dealers and associated persons to produce, in the context of a FINRA investigation, books and records "in the possession, custody or control" of the broker-dealer or associated person. The rule's supplementary material states that this includes not only records relating solely to a FINRA investigation of broker-dealer business, but also to outside business activities, private securities transactions, or possible violations of just and equitable principles of trade or any other securities law requirements.

This could, for example, facilitate FINRA investigations into purely investment advisory activities of firms that are registered both as broker-dealers and investment advisers.

Indeed, the vague language of the amendment suggests that **FINRA may use this rule not only to obtain information about securities-related activities of affiliated investment advisers, insurance companies and parent holding companies, but also to explore unrelated businesses in which the broker-dealer, or more likely an associated person, has a business interest.** Bolstering this supposition is a supplementary material statement that a production demand "does not ordinarily include books and records that are in the possession, custody or control of a member or associated person, but whose bona fide ownership is held by an independent third party and the records are unrelated to the business of the member." This suggests that, at least in some circumstances, FINRA could demand information wholly unrelated to broker-dealer business.

The amendments stem in part from a 2006 action against Jay Ochanpaugh in which FINRA sought records relating to questionable church activities directed by a registered representative. The representative refused to produce copies of checks drawn on the church's account and the SEC, noting the absence of "possession, custody or control" language in Rule 8210, refused to enforce FINRA's production demand.

Mandatory Class Action Waivers Upheld

BY MICHAEL WOLGIN

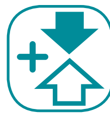
A hearing panel has ruled that FINRA cannot prohibit a broker-dealer from requiring customers to waive their right to bring or participate in a class action against the broker-dealer.

The panel's February 21, 2013 decision continues a controversy in which FINRA's Department of Enforcement has challenged mandatory pre-dispute arbitration provisions that include such class action waivers in Charles Schwab & Co. customer account agreements. Schwab began including such waivers in 2011, and many other broker-dealers also would certainly like to. However, Schwab has recently announced that, pending final resolution of the legal issue, it is removing the class action waiver provision for disputes concerning events occurring on or after May 15, 2013.

The panel agreed with the Department that Schwab's class waiver provision violated FINRA rules. However, the panel concluded that, **under *AT&T Mobility LLC v. Concepcion* and other Supreme Court precedent applying the Federal Arbitration Act, "the FAA bars enforcement of FINRA's Rules to the extent that the Rules" permit bringing a judicial class action, "despite any pre-dispute agreement to resolve disputes in arbitration."**

Schwab announced it was "pleased" with the decision, and believes that "customers are better served" through arbitration, rather than "cumbersome and less effective" class action lawsuits. FINRA, for its part, is appealing the decision to FINRA's National Adjudicatory Council. Whatever the outcome there, the matter may be reviewed by the SEC or, once again, in federal court. See "Court Rebuffs Schwab's Challenge to FINRA on Class Arbitration Ban" in *Expect Focus,* Volume II, Spring 2012.

The hearing panel decision also addressed a Schwab customer agreement provision purporting to deprive arbitrators of the ability to combine individual claims into consolidated arbitration proceedings. However, the panel ruled that FINRA could enforce its rules against such a provision, because the panel viewed the provision as merely addressing the procedures to be followed in arbitrations in a way that did not contravene the FAA's policy favoring agreements to arbitrate.



Supreme Court Rejects SEC "Discovery Rule" Argument

BY BEN SEESSEL

The U.S. Supreme Court held on February 27, 2013 that the statute of limitations applicable to SEC enforcement cases and proceedings runs from the time a fraud occurs, not when the SEC discovered or with reasonable diligence could have discovered the fraud under the "discovery rule."

In *Gabelli v. SEC*, the Court construed 26 U.S.C. § 2462, which provides: "an action … for the enforcement of any civil fine, penalty, or forfeiture … shall not be entertained unless commenced within five years from the date when the claim first accrued." Although § 2462, and hence the Court's opinion, applies both to court cases and administrative proceedings, its main practical consequence may be to cause the SEC to commence formal actions sooner or to seek "tolling agreements" more frequently.

Moreover, drawing on footnotes in the opinion, an official at the SEC reportedly commented: "This ruling pertains only to penalties and does not restrict our ability to strip violators of their unlawful financial gains or bar them from the securities industry when necessary to protect investors." Given § 2462's application to actions "for the enforcement of any civil fine, penalty, or forfeiture," it is not clear that this official's interpretation is correct; the *Gabelli* opinion does not address what these terms mean.

The official also pointed out that **the Court "left open whether the SEC can pursue financial penalties after five years when violators have taken steps to conceal their illegal conduct, such as submitting false information in a Commission filing."** The Court also specifically reserved judgment on whether the five-year limit would apply to any injunctive relief sought by the SEC.

SEC Rides Herd on Adviser Custody Arrangements

BY ED ZAHAREWICZ

One out of three advisers recommends that you pay close attention to your firm's compliance with Investment Advisers Act Rule 206(4)-2, better known as the "custody rule."

Well, not quite. The SEC National Examination Program has identified custody-related issues in one-third of recent examinations that found significant deficiencies. The NEP published its findings in a March 4th Risk Alert, which it hopes will assist advisers in complying with the custody rule.

The Alert lists a wide variety of circumstances in which advisers may fail to recognize that they are deemed to have "custody" of client assets or fail to comply with all applicable requirements relating to:

- "surprise exams" by independent accountants,
- use of "qualified custodians," or
- the "audit approach" that pooled investment vehicles may use to satisfy certain of the rule's requirements.

Such deficiencies have required advisers to take remedial measures such as enhancing written compliance procedures, changing business practices, and devoting more resources to the area of custody. The Alert also emphasizes that custody-related deficiencies have resulted in some enforcement referrals and subsequent litigation.

The custody rule was significantly amended in 2010 in the wake of the Madoff Ponzi scheme, and the SEC since then has been admonishing advisers to ensure full compliance. In conjunction with the Risk Alert, the SEC also issued an Investor Bulletin to provide investors with information they should know about the custody rule and the manner in which their adviser may maintain custody of their assets.

Clearly, the SEC staff is now taking a hard look at adviser custody arrangements and seems intent on putting some bite behind its bark. The Risk Alert suggests that advisers take stock of their custody practices, and the deficiencies discussed in the Alert provide a useful checklist to start that process.

Can Securities Regulators Make Harmony?

BY TOM LAUERMAN

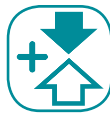
Whether and how to "harmonize" the disparate regulatory schemes that apply to broker-dealers and investment advisers continues to absorb regulators' attention.

Most prominently, the SEC on March 1 released a massive request (summarized in a March 6 Jorden Burt Client Alert) that the public supply it with extensive cost/benefit data and other information prefatory to possible rulemaking. Although the deadline for responding is not until July 5, 2013, we can safely predict that a variety of major interest and advocacy groups will continue to press the SEC to harmonize broker-dealer and investment adviser regulation in one way or another. **In many cases, however, what one group would consider harmonious, the next group would consider more or less cacophonous—and some judge the status quo to be quite musical enough.** Nevertheless, given the number and size of the groups that seem to be tuned up and eager to play, it is not surprising that the SEC shows at least some forward motion on this project.

Even within the SEC, however, the project is turning out to have multiple facets, not all of which might have been predicted. For example, the SEC's Office of Compliance Inspections and Examinations recently issued a list of its examination priorities for 2013. The list singles out for special examination attention firms that are dually registered as both broker-dealers and investment advisers—presumably because of the regulatory and compliance complications that can arise from the different rules and standards that apply depending on which "hat" a dually-registered person is wearing in a given transaction. Thus, it seems that the harmonization project may be influencing OCIE's examination focus (and perhaps also the focus of other operational units within the SEC) in ways that develop information and experience that will be of use to the SEC in formulating its ultimate conclusions on the harmonization question.

Similarly, FINRA often takes actions in the course of its day-to-day regulation of broker-dealers that could develop its knowledge base and experience to also include certain activities of investment advisers. A recent example of this is discussed in "Pushing Boundaries: Not Just for Kids" on page 14. Knowledge and experience with investment advisers could burnish FINRA's argument that it (or an affiliate) is well suited to be a self regulatory organization (SRO) for investment advisers. Although legislation requiring investment advisers to be SRO members has not as yet been reintroduced in the current Congress, FINRA certainly has not abandoned its ambition to fill this role. That ambition, moreover, is merely one aspect of FINRA's broader and continuing preference for investment adviser regulation that is more similar to broker-dealer regulation.

State securities regulators also are weighing in on certain aspects of harmonization. For example, "Blue Sky Regulators Attack Pre-Dispute Arbitration Agreements" on page 17 describes one area in which the North American Securities Administrators Association is pushing Congress and the SEC to mandate requirements that are similar for broker-dealers and investment advisers. As discussed there, moreover, NASAA's effort extends harmonization one step further to also cover investment advisers that, because of the exclusion of smaller advisers from SEC regulation, are subject only to state regulation and therefore would not otherwise be part of the SEC's harmonization project.



SEC's Summary VA Prospectus: How Patient Should We Be?

BY GARY COHEN

Many would say ***It's About Time!*** The summary variable annuity prospectus has become a top priority at the SEC.

Norm Champ, Director of the Division of Investment Management, recently made the welcome announcement that the Division "is beginning work on a rule" that would create a "streamlined" disclosure document "similar" to that for mutual funds. Emphasizing the SEC's goal "to enhance the transparency of the benefits, risks, and costs" for "investors considering variable annuities," Champ lauded the summary fund prospectus as "a revolution in communicating to investors the core information they most want while simultaneously making more detailed information readily accessible."

The industry has grown impatient since the SEC approved a summary fund prospectus – more than four years ago. Conversations with the SEC staff suggest that **the delay is largely attributable to the fact that the Division has had three Directors in four years and the Dodd-Frank and JOBS Acts preempted rulemaking resources.**

As for timing, Champ's Deputy, David Grim, has talked about a one-year period, but it remains unclear whether this means one year until the SEC adopts or proposes a summary VA prospectus or an earlier stage such as when the Division has a rule to recommend to the Commissioners. In any event, Champ listed the summary VA prospectus as *fourth* overall in rulemaking priority, following three "short term" rules (money market funds, identity theft and valuation) and preceding four "longer term" rules (ETFs, reporting frequency, private funds, and derivatives).

How confident can the industry be with this?

Champ said that the lists were the result of "a very thoughtful and deliberate approach" done "in close consultation with the Chairman [then, Elisse Walter] and the Commissioners."

Blue-Sky Regulators Attack Pre-Dispute Arbitration Agreements

BY SCOTT SHINE

As part of its 2013 legislative agenda, the North American Securities Administrators Association, Inc. (NASAA) has sent a letter to SEC Chairman Mary Jo White urging the SEC to propose rules prohibiting or conditioning the inclusion of pre-dispute agreements mandating arbitration in customer agreements of broker-dealers and investment advisers that are registered with the SEC.

Section 921 of the Dodd-Frank Act gives the SEC authority to adopt such rules. But **NASAA has publicly stated that, if the SEC fails to take action, it will urge Congress to pass legislation to dramatically curb the use of mandatory arbitration provisions.** NAASA also says it will seek federal legislation to authorize states to curtail the use of such provisions by those investment advisers who are regulated only by the states. Congressional action might be required for this purpose, inasmuch as the SEC's authority under Section 921 does not extend to those state-regulated advisers.

NASAA is motivated in part by a recent decision that mandatory pre-dispute arbitration provisions can require customers to waive their right to participate in class actions against a broker-dealer (see "Mandatory Class Action Waivers Upheld" on page 14). NASAA has filed an amicus brief urging FINRA's National Adjudicatory Council to overturn that decision, and is also urging the SEC to overturn the decision if the Council does not.

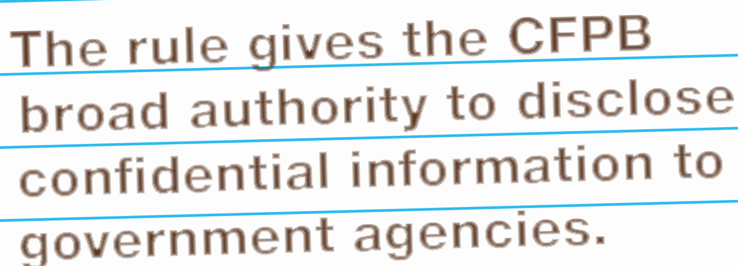
The CFPB'S New Rule on Disclosure of Records and Information

BY ELIZABETH BOHN

On March 18th, the Consumer Financial Protection Bureau's rule on Disclosure of Records and Information (the Rule) became effective. The 51-page Rule sets forth detailed procedures for the public to obtain information from the CFPB under the federal Freedom of Information Act (FOIA), and in litigation. It also regulates disclosure of the Bureau's confidential consumer complaint, investigative and supervisory and other confidential information, and incorporates the Privacy Act of 1974 (the Privacy Act) with respect to information concerning individuals.

Privacy Act

Sub-part E of the Rule applies to information concerning individuals which is retrieved by an individual's name or personal identifier. Individuals will generally be able to request access to and request amendment of information applicable to them, upon complying with the steps required for verification of the individual's identity. Individual-specific information will otherwise be protected from disclosure.



Confidential Information

The Rule defines the term "confidential information" to include confidential consumer complaint, investigative and supervisory information, and information exempt from disclosure under FOIA. "Confidential consumer complaint information" means information generated or received by the Bureau in connection with specific consumer complaints. "Confidential investigative information" includes information received in response to civil investigative demands. Among other things, Sub-part C of the Rule *requires* the Bureau to disclose confidential consumer complaint information to federal or state agencies to facilitate its enforcement activities, and gives it *discretion* to disclose such information to federal or state agencies who request it in connection with exercise of their regulatory authority. It also *permits* the CFPB to disclose such information in summary form to law enforcement agencies and other governmental agencies to notify them of potential violations of law, and to disclose confidential consumer complaint information "as it deems necessary" to investigate or respond to consumer complaints.

FOIA Requests

Records which the Bureau obtains from businesses and other entities not covered by any of the restrictions on disclosure of confidential information may be subject to disclosure under sub-part B of the Rule, which implements the federal Freedom of Information Act (FOIA).

This part provides that subject to the exemptions and exclusions under §522(b) and (c) of FOIA, the CFPB generally "shall promptly make its records available to any person pursuant to a request that conforms to the Rule's procedures," thus granting the public an enforceable right to access CFPB records other than those concerning individuals absent FOIA's statutory exemptions or exclusions. The Rule also creates an affirmative duty upon corporations and other entities from whom the CFPB obtains business information (Submitters) to designate, "at the time of submission or at a reasonable time thereafter," information that the Submitter considers protected from disclosure under the FOIA exemption for confidential trade secrets and commercial and financial information.

Submitters who have designated documents as entitled to the FOIA exemption are entitled to notice from the CFPB on receipt of a request encompassing that information and given 10 days to object. However, the CFPB may overrule the Submitter's objections and nevertheless disclose the documents 10 days after notifying Submitter that its objections have been overruled, leaving the Submitter the remedy of suing to enjoin disclosure in federal court within that period. The CFPB does not have to give any notice of receipt of a request for the Submitter's information if it determines a designation is "obviously frivolous," or if the disclosure is required by statute. The CFPB also has the right to elect not to apply a FOIA exemption, "if not otherwise precluded by law," if the Bureau "finds no necessity of applying the exemption," with respect to a particular request.

The Rule thus gives the CFPB broad authority to disclose confidential information to the relevant governmental agencies. It also authorizes the CFPB to elect not to apply FOIA exemptions to FOIA requests, and to overrule objections to disclosure of business information in response to such requests. Moreover, if the Submitter did not designate its information as exempt from disclosure under FOIA at the time of submission, then, unless the CFPB independently determines the information is exempt, the entity which provided the information is not entitled to notice that a request for its information has been received.

The full text of the Rule may be found here: *https://www.federalregister.gov/articles/2013/02/15/2013-01737/disclosure-of-records-and-information*.

CFPB Publishes Revealing Data on Consumer Complaints

BY ELIZABETH BOHN

The CFPB currently accepts consumer complaints about credit cards, mortgages, bank accounts and services, student loans and other consumer loans, and credit reporting. After screening the complaints, the Bureau forwards them to the companies for response, and attempts to reach a resolution between the consumer and the company subject to the Complaint.

The Bureau regularly publishes data about all complaints it receives, including the name of the company involved and the nature of the complaint. The most recently published data covers the more than 131,000 consumer complaints received by the Bureau since it first began accepting credit card related complaints in July 2011, and reflects that 49% of the complaints have been directed to mortgage products, 23% to credit cards, and 15% to bank accounts and services, including overdraft, late fees and other charges. Credit reporting, student loans, and other consumer loans comprised 5% or less of the remaining complaints.

More than 60% of mortgage-related complaints involved problems consumers claimed to have experienced when unable to make payments, including loan modification and foreclosure-related issues with consumers complaining about lost documentation and difficulties in modifying their loans. Twenty-two percent of mortgage complaints are related to making payments, including loan servicing and escrow account issues. The remaining 15% of mortgage complaints have been directed to: (1) loan application process, 7%; (2) signing the agreement, 3%; (3) credit offers, 2%; and "other," 3%. **For credit cards, the most frequent complaints involved billing disputes, APR issues, and identity theft followed by credit reporting and account closing/cancellation issues.**

Data describing the date, nature, and disposition of all of the complaints, including the names of the companies complained about is published on the Bureau's website, and can be sorted by entity so that all complaints against a particular institution can be seen listed simultaneously. Consumer attorneys thus have a database from which to mine information to use in class actions. No consumer names or other identifiable consumer information is published, in accordance with Privacy Act regulations.

ARBITRATION ROUNDUP

BY LANDON CLAYMAN

While arbitration aficionados eagerly await the U.S. Supreme Court's rulings in *Italian Colors Restaurant* and *Oxford Health Plans LLC*, lower courts have not failed to provide them with interesting decisions. *Parisi v. Goldman, Sachs & Co.* involved Title VII gender discrimination claims brought individually and on behalf of a putative class. Although the claims fell squarely within the scope of a valid arbitration agreement, the trial court held that because the agreement did not authorize class-wide arbitrations, it would make it impossible for plaintiff to arbitrate a Title VII pattern-or-practice claim (which plaintiff could bring only on behalf of a class). The court accordingly denied a motion to compel arbitration because the arbitration agreement in effect operated as a waiver of a substantive federal right under Title VII. The Second Circuit Court of Appeals reversed, holding that plaintiff did not have a "right" to bring a pattern-or-practice claim under Title VII, and that the class action Rule 23 mechanism *presupposes* the existence of a claim, and can not create a non-waivable right to bring such a claim.

In *Bakoss v. Certain Underwriters at Lloyds of London*, a disability insurance contract provided that each party had the right to have the insured examined by a physician of its choice to determine if the insured was "totally disabled." If the two physicians could not agree, they would jointly appoint a third physician to make a final and binding decision on the matter. The Second Circuit held that the third-party physician clause was an arbitration agreement, applying a broad definition: an agreement to submit a dispute to a specified third party for binding resolution is an agreement to arbitrate. In addition, the Second Circuit took sides in a circuit split, holding that federal common law, rather than state law, provides the definition of "arbitration" under the Federal Arbitration Act.

CFPB Continues to Target "Add-ons"

BY ELIZABETH BOHN

During the past 15 months, the CFPB has found that consumers have been misled in the marketing and sales of "add-on" financial products offered with credit cards. As a result, it has issued two guidance bulletins, and, jointly with banking regulators, entered into two consent enforcement orders assessing several hundred million dollars in penalties against two credit card banks for deceptive marketing practices in the offering and sale of such products.

In a Guidance Bulletin issued in April 2012 (April Bulletin), the Bureau stated that third-party service providers to banks and other non-bank consumer financial service providers (supervised entities) were also subject to CFPB supervision, and, that the supervised entities would be held responsible for violations by their third-party service providers of federal consumer financial law. The CFPB further expressed its expectation that supervised entities conduct due diligence and monitoring of the activities of third-party service providers to ensure their compliance with the law.

Add-on products marketed by third-party vendors were the subject of the CFPB's very first public consent enforcement order, entered jointly with the OCC against Capital One Bank in July 2012. The add-on products subject to that Order were described as "payment protection," which allowed consumers to request cancellation of minimum payments during disability or unemployment, debt forgiveness, credit monitoring services, and identity theft protection. These products were offered to consumers with low credit scores by call center vendors when the consumers called to activate their cards.

The CFPB found that the bank's call center vendors misled the consumers about the nature, benefits, and costs of the products. For example, according to the CFPB, customers were led to believe the products would raise their credit scores and help increase their credit limit on the cards. The Bureau further asserted that customers were misled about eligibility and were enrolled without their consent. The bank was required to refund $140 million to consumers and assessed a $25 million penalty.

Another CFPB Bulletin issued in July 2012 directed supervised entities to take steps to ensure that terms and conditions of credit card add-on products were accurately reflected and not "deceptive or misleading" to consumers. These steps included, but were not limited to, reviewing marketing materials, telemarketing scripts, internet, print, radio and television ads, instituting and auditing compliance management programs, and overseeing and monitoring third-party marketing vendors. **The CFPB's expectations for oversight and monitoring of third-party vendor practices are so onerous, and the consequences of potential vendor violations so dire, that many supervised institutions have simply stopped using them.**

In September 2012, the CFPB and FDIC entered a second consent enforcement order relating to credit card add-on products against Discover Bank. That order again involved payment protection, identity theft protection, and credit score tracker products, which were telemarketed between 2007 and 2011 to card members. In this case, the CFPB found the telemarketing scripts used were deceptive, allegedly implying that the product was a free benefit, rather than a program involving an additional fee, and askeing the cardmember to "enroll" in a product, while failing to disclose that enrollment constituted an agreement to purchase the product. Among other things, the order required the bank to pay $200 million in restitution to the customers who purchased the products.

It has been widely reported that the CFPB recently issued subpoenas concerning the sale of auto warranties, insurance, and other financial products in the auto lending industry. These add-on products, found in a large percentage of vehicle finance contracts, are sold by dealers and included in the total vehicle price financed in finance contracts. While auto dealers are exempt from the CFPB, the indirect lenders who purchase the deals are not. In March, the CFPB issued a guidance bulletin stating that it would hold indirect auto lenders responsible for violation of fair lending laws if interest pricing in finance contracts originated by dealers resulted in a disparate impact.

The CFPB's scrutiny and entry of enforcement orders related to credit card add-on products suggests that it may do the same with respect to add-on products offered by other consumer financial product providers who offer such ancillary products.

U.S. Supreme Court Applies "First Sale" Doctrine to Foreign-Made Copies of Copyrighted Works

BY JOHN PITBLADO

On March 19, 2013, the U.S. Supreme Court issued its opinion in *Kirtsaeng v. John Wiley & Sons, Inc.*, a much awaited pronouncement on the "first sale" doctrine as applied to copies of copyrighted works made outside the United States. The Court reversed the Second Circuit, and the district court opinion it had affirmed, finding that the petitioner, Supap Kirtsaeng, did not violate U.S. copyright law by re-selling foreign-made copies of textbooks.

Supap Kirtsaeng is a Thai national who came to the U.S. for college. Recognizing that his textbooks were cheaper if purchased by his family at bookstores in Thailand, he started re-selling them by the hundreds on eBay, and ultimately netted a profit in the range of $100,000. When publisher John Wiley & Sons learned of the sales, it sued Kirtsaeng for copyright infringement. A New York federal court found in favor of the publisher and awarded $600,000 in damages. The Second Circuit Court of Appeals affirmed. Kirtsaeng petitioned the U.S. Supreme Court for review and, in a 6-3 decision authored by Justice Breyer, the Court reversed.

The case involved interpretation of the "first sale" provision of the Copyright Act, which states that "[n]otwithstanding the provisions of [the Act], the owner of a particular copy … lawfully made under this title … is entitled, without the authority of the copyright owner, to sell … that copy." Kirtsaeng argued that copies made outside the United States are nevertheless "lawfully made under this title," because they were made under a license from Wiley to its Asian subsidiary, pursuant to Wiley's U.S. Copyright. Wiley argued that the "first sale" defense is inapplicable because copies made overseas are not made "under this title" because "this title" does not apply overseas.

The Court rejected Wiley's arguments and adopted Kirtsaeng's view that "lawfully made under this title" means made under U.S. copyright laws, without any geographical limitation. Because Wiley authorized the making of the copies under a U.S. copyright, the copies were "lawfully made under this title," so the first sale doctrine applied.

While no legislation in response to the decision has been proposed as of this writing, there are differing views as to whether this issue will now be taken up in the legislative sphere. As noted in *Forbes*, Gary Shapiro, President and CEO of the Consumer Electronics Association believes it will not and points to 1984, when the Court upheld the first sale defense for U.S.-made works. Legislation introduced thereafter died in Congress. Goodwill Industries International (GII), takes the contrary view, noting on its website that "[r]egardless of how the court rules, we expect the issue will be taken to Congress and the fight will continue.

The decision has profound implications for copyright owners, on the one hand, and consumers and distributors, particularly of used works, on the other. One can imagine that eBay—the platform on which Mr. Kirtsaeng sold his foreign copies – Amazon, Craigslist and the like, hail the decision as a boon to their business. On the other hand, copyright owners like John Wiley & Sons must now turn to other options, like pushing new legislation or ensuring that they protect themselves through contract rights in their licensing relationships with foreign copy makers, and with end-users/consumers.

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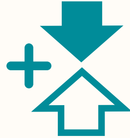

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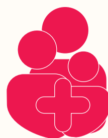

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