EXPECTFOCUS®

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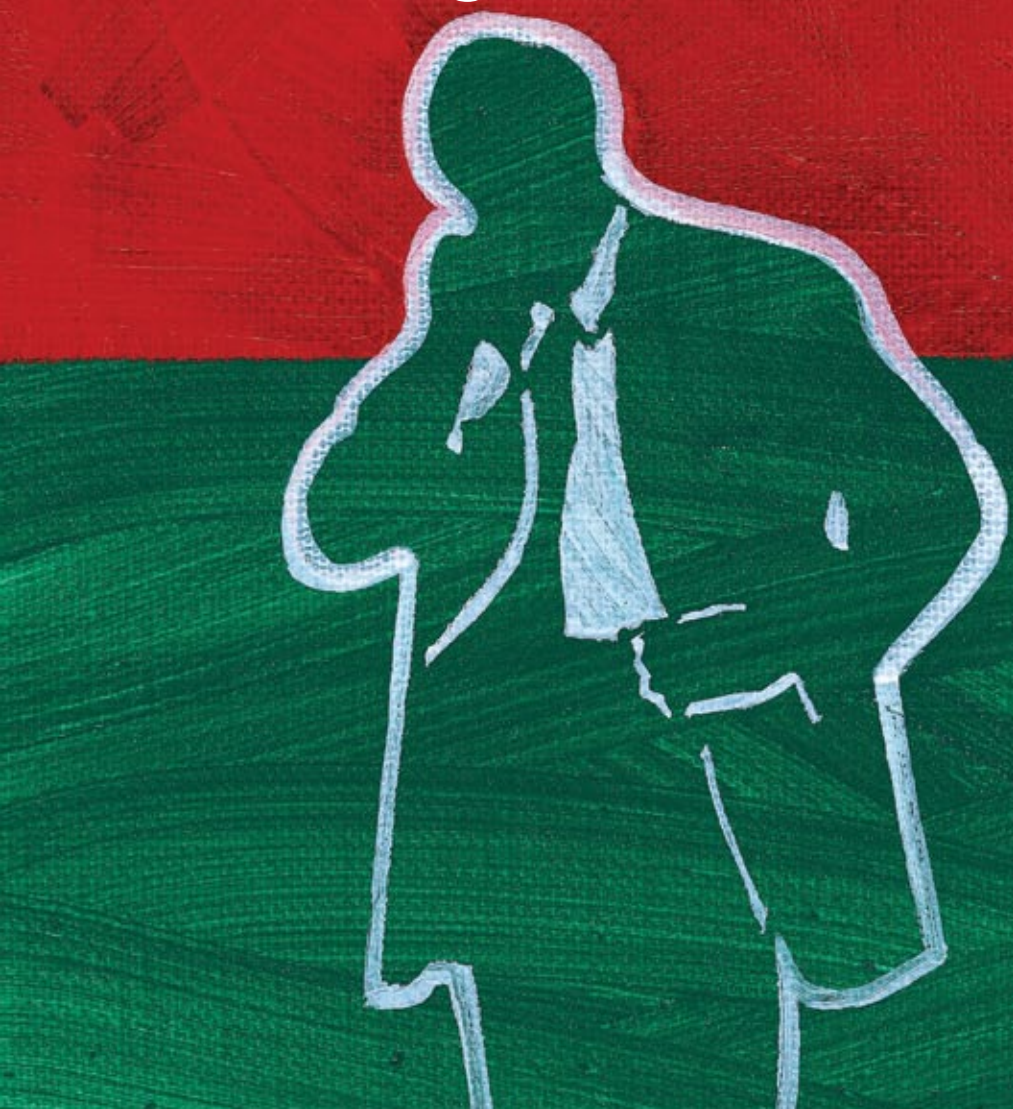
Nobody Said This Would Be Easy

Making tough calls in tough times



JORDEN BURT LLP

EXPECT**FOCUS**® Vol. III SUMMER 2010

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Moira Demyan
mfd@jordenusa.com

Rule 151A Crushed by Court, Congress

BY GARY COHEN & KRISTIN SHEPARD

SEC Rule 151A—designed to subject fixed indexed annuities to regulation under the federal securities laws—has been judicially vacated and legislatively overridden. On July 12, 2010, the U.S. Court of Appeals for the D.C. Circuit vacated the Rule as a result of the SEC's "arbitrary and capricious" failure to perform the required analysis of the effect of the Rule on efficiency, competition, and capital formation. On July 21, 2010, President Obama signed into law the Wall Street Reform and Consumer Protection Act (DFA), which includes an amendment that effectively precludes the SEC from reissuing the Rule.

For those opposing the rule, Congress and the court bowl a strike

The SEC, however, may claim limited victories in that: (1) the DC Court of Appeals upheld as reasonable under Chevron the SEC's interpretation that indexed annuities are "annuity contracts" exempted from securities regulation under the Securities Act of 1933; (2) the DFA provides that it shall not be construed to affect whether any other insurance product is or is not an exempt security; and (3) the DFA addresses certain suitability concerns that prompted the SEC's regulation of indexed annuities.

Central here is that **qualification for the securities exemption for indexed annuities is linked to compliance with March 2010 NAIC Suitability in Annuity Transactions Model Regulation** (or state law equivalent), which seeks to bring state insurance suitability standards in line with the suitability standards currently imposed on the securities industry. Further, the new financial reform legislation contains provisions designed to provide funding to the states to combat the sale of annuities and life insurance to seniors through the use of fraudulent or misleading Senior-Specific Certifications and Professional Designations.

Will the SEC be content with this limited success? Will it instead seize on the raft of regulatory initiatives required by the DFA or resort to back-door cooperation with FINRA or even the states in order to further regulate the sale of indexed products? One possible indicator: SEC Chairman Mary Schapiro testified before the House Committee on Financial Services on July 14, 2010, reiterating her longstanding "concerns" about how indexed annuities are sold, and stating that **although the SEC would not "re-engage" in efforts to directly regulate indexed annuities as securities, it would volunteer its assistance to state insurance commissioners** in their efforts to regulate the sale of indexed products.

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MORE NEWS FROM THE LIFE INSURANCE GROUP

Insurers May Use Retained Asset Accounts

BY ANN BLACK & KAREN BENSON

In the face of negative press involving insurers' use of retained asset accounts (RAAs) for the payout of policy benefits, members of Congress and a newly formed NAIC RAA Working Group are examining insurers' use of RAAs. While some seek to limit or prohibit RAAs, recent cases and comments from various insurance regulators reflect that if the appropriate language is included in policies and if the RAA program is properly disclosed and administered, RAAs are generally permissible.

With the right policy language, courts generally permit RAAs

MONY Life Insurance Company won summary judgment in a class action asserting breach of contract and tort claims because it paid surrender proceeds through an RAA. Finding that the **policies allowed other methods of disbursement** and the distinction between an RAA and a check was de minimis, the court concluded that the insurer was not obligated to pay surrender proceeds by check. Additionally, the court found that the RAA paid a "competitive rate" as described in the materials for the RAA and that **the insurer did not engage in any misleading practices**. The decision was affirmed by the U.S. Court of Appeals for the Second Circuit.

Following the negative press involving a case of its payment of veterans' death benefits via an RAA, Prudential Insurance Company of America was sued in federal district court in Massachusetts. The class action contests the insurer's profits on veterans' death benefits held in the RAA. Claims include breaches of contract, fiduciary duty, and the implied covenant of good faith and fair dealing. It was subsequently reported that the New Jersey Department of Banking and Insurance found Prudential acted appropriately in the case reported negatively in the press.

While some decisions have been favorable, some courts have sided with plaintiffs. Thus, **appropriate policy language and disclosure and administration of an RAA is essential**. Given the increased scrutiny and some unfavorable litigation outcomes, insurers should review their policies and RAA program. Updates to insurers' RAA programs are likely to be needed due to legislative and regulatory initiatives. See our client alert on the NAIC RAA Working Group's August 27, 2010 meeting.

Consumer Protection Law Claims in Deferred Annuity Cases
A Mixed Bag of Results

BY DAWN WILLIAMS

The U.S. District Court for the Northern District of California recently **allowed an estate's special administrator to be substituted as a plaintiff in a class action alleging statutory violations**, including California's Unfair Competition Law. The plaintiff in *Rand v. American National Ins. Co.* claimed that the insurer made misrepresentations and omissions in the sale of deferred annuities to an 86-year-old who died shortly after bringing suit. The defendant claimed that the administrator could not be substituted because she was not present at the sale and therefore could not provide evidence of reliance or causation. The court found those issues were better determined on summary judgment and that, in any case, reliance was only necessary for the "fraud" prong of the UCL but not the "unfair" or "deceptive" prongs. The court also rejected the insurer's argument that upon the annuitant's death the interests of the beneficiaries became vested, because the plaintiff was claiming injury in the purchase of the policies and imposition of surrender charges prior to death.

Another insurer fared better in federal court in Pennsylvania, where a magistrate recommended granting summary judgment in its favor on Pennsylvania consumer protection law claims. In *Smith v. National Western Life Ins. Co.*, plaintiff claimed that the insurer was liable for violating notice provisions and committing fraud. The court rejected the notice argument, finding that plaintiff had been given the required free look notification, and that the notice satisfied any other notification provisions in the Pennsylvania code. As to the fraud claim, the **court found that the alleged deception concerned the suitability of the product**, not the contract terms, that the salesperson was acting as the insured's agent, and **that National Western had not authorized the agent to sell an unsuitable policy**.

A Common Course?
California Federal Courts Certify Two Deferred Annuity Lawsuits

BY PAUL WILLIAMS

Two California federal courts recently certified nationwide and California-only classes of senior deferred annuity purchasers in strikingly similar cases. In each instance, the courts held that written marketing material allegedly misrepresenting and/or omitting essential characteristics of the products were sufficient to determine that common questions predominated over individual ones as to the elements of plaintiffs' claims.

Uniform written materials steering courts towards class certification

In the *In re National Western Life Insurance Deferred Annuities Litigation* proceeding, plaintiffs had filed a motion to certify a nationwide class based on violations of RICO, and a California-only class based on false advertising, financial elder abuse and violation of California's unfair competition law. Plaintiffs alleged a common course of conduct to misrepresent the essential characteristics of the deferred annuities in the use of **standardized written materials**, and also that the **defendant had concealed hidden costs**.

While the U.S. District Court for the Southern District of California initially denied plaintiffs' class certification motion, plaintiffs' renewed motion, which narrowed their allegations to just four annuity products, achieved a different result. The court focused primarily on the predominance requirement, finding the requirement satisfied because **the defendant made its allegedly false and misleading claims in writing, uniform in material part,** to each class member.

Likewise, in *Kennedy v. Jackson National Life Insurance Company*, the U.S. District Court for the Northern District of California found sufficient evidence of a common course of conduct in the defendant's alleged uniform misrepresentation of the annuities' "bonus" feature and alleged failure to disclose the market value adjustment feature of the annuities and the effects of its agent commissions even though defendant did not enforce a standardized sales pitch or uniform presentation scripts.

No Trebling of Restitutionary Unfair Competition Law Awards

BY JOHN KIMBLE

California's Supreme Court **has limited the scope of treble damage awards** in an action involving claims that the defendant insurance companies violated California's Unfair Competition Law by using deceptive business practices to induce seniors to purchase annuities with high commissions and large surrender penalties. The court of appeal in *Clark v. Superior Court* had held that plaintiffs' restitution remedy could be trebled under California Civil Code § 3345, which allows for trebling of damages where the trier of fact "is authorized by statute to impose a fine, or a civil penalty or other penalty, or any other remedy the purpose or effect of which is to punish or deter," reasoning that restitution could have a deterrent effect. The Supreme Court of California reversed on statutory construction grounds, holding that because "[a]ll remedies have some incidental deterrent effect," the deterrence language, and thus the trebling provision itself, applied only to remedies in the nature of penalties. Thus, the court concluded that **a claim for restitution (a remedy pertaining to recovery rather than punishment) does not fall under the trebling provision**. Jorden Burt LLP submitted an amicus brief espousing the positions adopted by the California Supreme court.

Restitution isn't punishment says the California Supreme Court

Suitability Exam Procedures Reveal Regulators' Expectations

BY ANN BLACK

On July 8, 2010, the NAIC Market Conduct Examination Standards (D) Working Group (Examinations WG) **released a draft of the proposed examination procedures** (the "Suitability Exam Procedures") to evaluate an insurer's compliance with the NAIC Suitability in Annuity Transaction Model Regulation (Suitability Model). The Suitability Exam Procedures, which will be incorporated into Chapter 19 (Conducting the Life and Annuity Examination) of the Market Regulation Handbook, offer insight into state insurance regulators' expectations with respect to insurers' suitability obligations.

Insurers may have to spruce up their suitability assurance procedures

As expected, the Suitability Exam Procedures include reviewing an insurer's suitability program. In many instances, the Suitability Exam Procedures instruct examiners to assess whether the insurer's suitability procedures are "adequate" or "effective" without any guidance on what constitutes such standards. The Suitability Exam Procedures also reflect the **presumption that the insurer's suitability program include "verification" or testing procedures**. Examiners are, thus, instructed to determine if an insurer's suitability program **includes procedures to verifiy that its producers**:

(i) treat and classify **replacements consistent with the suitability regulation**.
(ii) have taken **reasonable efforts to obtain the consumer's suitability information**.
(iii) are supervised and are in compliance with requirements on suitability.
(iv) **are trained in the insurer's standards for annuity product training**, applicable state statutes, rules and regulations regarding solicitations, recommendation and sale of annuity products.
(v) comply with annuity product continuing education requirements.

Also, examiners must **verify that the insurer**:

(i) treats and classifies replacements consistent with the suitability regulation.
(ii) **has not issued a recommended annuity unless there was a reasonable basis to believe the annuity was suitable**.
(iii) maintains reasonable procedures to inform producers of their suitability obligations.
(iv) obtains certifications from third parties who perform suitability obligations on its behalf.

The Suitability Exam Procedures also instruct examiners to review specific materials in the policy file. This reflects an expectation for fulsome policy files for each annuity transaction.

In addition, the Suitability Exam Procedures reflect the regulators' training expectations, including that an insurer will have **"adequate product-specific training and training materials which fully explain all material features of its annuity products."** Several examination techniques test producers' compliance with the training requirements before they sell annuity products.

At the July 20, 2010 Examinations WG meeting, several interested parties expressed concerns that the Suitability Exam Procedures impose suitability obligations beyond those in the Suitability Model. The due date for comments on the Market Conduct Suitability Procedures was September 1, 2010, and the comments will be discussed at the Examinations WG September 16, 2010 meeting.

Mark Your Calendars

The ALI-ABA Conference on Life Insurance Company Products will be held October 28-29, 2010 at the Hyatt Regency in Washington, DC. Co-chaired by **Richard Choi**, partner in the Washington office, this conference will focus on issues stemming from the Dodd-Frank Act, as well as other recent legislative, regulatory, and compliance developments relevant to insurance companies, broker-dealers, investment advisers, mutual fund organizations, and banks involved with these products. **Gary Cohen** and **Ann Furman**, also partners in the Washington office, serve on the faculty. For more information and to register, visit www.ali-aba.org.

Supreme Court to Clarify Standards for Recovery Due to Allegedly Deficient Summary Plan Description

BY JASON MORRIS

If the U.S. Supreme Court affirms the Second Circuit's decision in *Amara v. CIGNA Corp.*, plan participants suing ERISA plans **might not be required to demonstrate reliance and prejudice as a result of a deficient summary plan description in order to recover**. The result could be increased expenses, liabilities, and headaches in connection with the maintenance and amendments of ERISA plans.

After a bench trial, the U.S. District Court for the District of Connecticut ruled in favor of the plaintiffs, holding that the employer, CIGNA, failed to provide a key notice to employees required by ERISA in effectuating transitions from traditional defined benefit plans to cash balance plans. In a one-page opinion affirming the lower court rulings, **the Second Circuit became the first federal court of appeals to adopt the "likely harm" standard**, which enables a plan participant to recover when he or she was likely to have been harmed as a result of deficient notice in a summary plan description.

The Supreme Court granted certiorari on June 28, 2010 and, in doing so, set itself the task of resolving **a three-pronged circuit split** regarding the showing required to recover based on an inconsistency between the summary plan description and the Plan. The First, Fourth, Seventh, Eighth, Tenth, and Eleventh Circuits require that a plan participant show reliance or prejudice resulting from the defective notice. In contrast, the Third, Fifth, and Sixth Circuits require no demonstration of prejudice, instead holding that a plan participant merely must establish a legal deficiency in the summary plan description in order to recover. The Second Circuit has attempted to fashion a compromise with its "likely harm" standard.

Although no argument date has been set, Jorden Burt LLP will continue to monitor developments in this matter.

HHS Proposes Revisions to Health Information Privacy Rules

BY JOHN KIMBLE

Endeavoring to implement the Health Information Technology for Economic and Clinical Health Act, strengthen the privacy and security protection of health information, and improve workability and effectiveness, on July 14, 2010, the Department of Health and Human Services (HHS) published a Notice of Proposed Rulemaking to modify the Health Insurance Portability and Accountability Act of 1996.

Several of the proposed changes, if adopted, will significantly alter the Standards for Privacy of Individually Identifiable Health Information. Proposed modifications include:

- **Expanding the definition of "business associates"** to include (a) patient safety organizations or those who conduct patient safety activities on behalf of covered entities; (b) Health Information Organizations, E-Prescribing Gateways, and other persons that facilitate data transmission, as well as vendors of personal health records; and (c) subcontractors;
- Applying certain Privacy Rule and Security Rule compliance requirements to business associates;
- Adding the sale of protected health information as a use or disclosure that requires the **express written authorization of the individual**; and
- Clarifying the right of an individual to restrict disclosures of protected health information to a health plan with respect to treatment services for which the individual has paid out of pocket in full.

HHS has solicited comments on these and other issues, to be submitted on or before September 13, 2010. Recognizing that it will be difficult for covered entities and business associates to comply with the statutory provisions until after the rules have been finalized, HHS provides 180 days beyond the effective date of the final rule to achieve compliance with most of the rule's provisions. Jorden Burt will continue to monitor developments in connection with privacy protections and obligations.

Santa's Helpers Entitled to Coverage

BY JONATHAN STERLING

Santa's Best Craft, LLC, et al v. St. Paul Fire and Marine Ins. Co., involved a coverage dispute under commercial general liability (CGL) policies for claims of intellectual property infringement brought against the insured. Santa's Best Craft, LLC (SBC), a Christmas lights manufacturer, was sued by a competitor, JLJ, Inc., which claimed SBC copied its packaging design and marketed its lights using deceptive language. SBC asked its insurer, St. Paul Fire and Marine, to provide a defense for JLJ's claims. When St. Paul failed to provide a defense, SBC filed a declaratory action in Illinois district court. St. Paul counter-claimed with its own declaratory action. While the declaratory action was pending, SBC settled the underlying suit with JLJ.

SBC's CGL policies covered advertising injury claims including "unauthorized use" of a "slogan." St. Paul argued that no coverage was available because JLJ had no exclusive right to the slogans on its packaging, and therefore could not have asserted an unauthorized use of slogan claim. The district court found, and the Seventh Circuit agreed, that the **allegations in the complaint suggesting the competitor had some claim of ownership over the slogans were sufficient to trigger a duty to defend**.

St. Paul also argued for application of the policies' intellectual property exclusion. Those provisions excluded coverage for violations of intellectual property laws, but excepted from the exclusions claims of unauthorized use of trademarked slogans in advertising. The district court and the Seventh Circuit found that the exclusions did not apply because, although some of the allegations in JLJ's action fell under the exclusions, the claims that fell under the exceptions were not dependent upon the excluded claims. The Seventh Circuit also affirmed the district court's holding that an exclusion for advertising materials in use before the policy period barred coverage under one of St. Paul's policies.

The Seventh Circuit agreed with the district court that St. Paul had a duty to defend SBC, but had not breached that duty, as St. Paul had complied with Illinois law by filing a timely declaratory action. However, the Seventh Circuit remanded the case for a determination as to whether, and to what extent, St. Paul was required to reimburse SBC for the settlement with JLJ, and whether it owed prejudgment interest on SBC's defense expenses. The Seventh Circuit stated that St. Paul would be liable for the settlement if covered claims were the primary focus of the settlement.

Policy Exclusions Bar Chinese Drywall Claims

BY LIAM BURKE

A Virginia federal court held that an insurer was not liable to a policyholder whose home was damaged by Chinese drywall. The court held that the policyholder's residence suffered a "direct physical loss" under the terms of the policy, but that four exclusions applied.

In *TRAVCO Ins. Co. v. Ward*, the homeowner sought coverage for the cost of removal and replacement of the Chinese drywall and for damage to structural, mechanical, and plumbing systems. TRAVCO denied the claim and sought a declaratory judgment that it was not liable under the policy. Specifically, TRAVCO argued that the residence did not sustain a "direct physical loss" under the policy, and even if there had been a "direct physical loss," it would be excluded under the latent defect, faulty materials, corrosion, and/or pollution exclusions.

The court held that the residence did sustain a "direct physical loss" because that phrase, as used in the policy, encompassed a total loss of use. However, the court also held that losses from defective Chinese drywall "fit squarely" within the **latent defect exclusion** because they were not reasonably detectable. In holding that the **faulty materials exclusion** applied, the court emphasized that in a related suit the policyholder had argued that the drywall was defective. Additionally, the court held that the **corrosion exclusion** unambiguously applied as the damage to the structural, mechanical, and plumbing systems was caused by corrosion. Finally, the court held that the **pollution exclusion** applied because while the drywall itself was not a pollutant, the reduced sulfur gases it releases are recognized as pollutants by state and federal authorities, and under Virginia precedent, if the harm was caused by the release of a pollutant, the pollution exclusion applies.

Prior Notice Exclusion Limits Recovery Under D&O Policy

BY JAMES GOODFELLOW

In *Axis Reinsurance Co. v. HLTH Corp.*, HLTH sought coverage under three separate claims-made D&O insurance programs for defense costs it incurred on behalf of its directors and officers in an underlying criminal investigation. **After two of the programs settled claims, HLTH sought coverage under the third program**, an insurance tower consisting of a primary policy and several excess policies.

Five of the six insurers in the third program denied coverage on the grounds that the program's Prior Notice exclusion precluded coverage. **The insurers asserted that HLTH had notified the other insurance programs roughly five months before it notified the insurers**, thus triggering the exclusion. The trial court agreed and granted the insurers' motion for summary judgment.

Failure to communicate to all insurers simultaneously triggered the prior notice exclusion

The Delaware Supreme Court affirmed. The court stated that the **unqualified broad language contained in the Prior Notice exclusion indicated that prior notice could be given by any entity with respect to any policy**. Because HLTH failed to give simultaneous notification to each insurance program, the Prior Notice exclusion properly barred all coverage. The court emphasized that HLTH's reading of the policy did not comport with the broad language contained in the exclusion, and concluded that HLTH should be bound by Delaware principles that an insurance contract is to be read "to accord with the **reasonable expectations of the purchaser** so far as the language will permit."

No Class for Insureds Seeking Deductible Reimbursement

BY BEN SEESSEL

In *Jones v. Nationwide Property and Casualty Insurance Company*, the Pennsylvania Superior Court affirmed dismissal of a class action complaint alleging that Nationwide's practice of reimbursing only a pro rata share of an insured's deductible constituted breach of contract, bad faith, conversion and unjust enrichment.

Look it up: pro rata deductible reimbursement allowed by statute

Plaintiff held a Nationwide collision policy with a $500 deductible. After plaintiff was involved in an auto accident, Nationwide paid plaintiff the amount of her loss, less deductible, and pursued a subrogation action against the other driver. Nationwide received more than the deductible amount, but less than what it had paid the plaintiff. **Nationwide reimbursed plaintiff $450 of the $500 deductible, which represented the pro rata share of Nationwide's recovery in the subrogation action.** Pennsylvania Insurance Department regulations provide that: "Insurers shall, upon the request of the claimant, include the first-party claimant's deductible, if any, in subrogation demands. Subrogation recoveries shall be shared on a proportionate basis with the first-party claimant."

Adopting reasoning from the Eastern District of Pennsylvania's opinion in *Harnick v. State Farm*, the court affirmed dismissal because plaintiff failed to state a claim. First, the court held that the Insurance Department clearly had the authority to promulgate the regulation at issue. The court next held that the **conduct complained of was specifically permitted by regulation**, and, accordingly, did not violate the "made whole" doctrine. As such, plaintiff failed to state a basis for her breach of contract claim. The court rejected plaintiff's bad faith claim because **Nationwide had acted in reasonable reliance on regulation** and, further, affirmed dismissal of the conversion and unjust enrichment claims because, under regulation, plaintiff was not legally entitled to a recovery of her entire deductible.

REINSURANCE

State Legislative and Regulatory Update

BY KAREN BENSON

New Jersey Reinsurance and Captive Insurance Bills. Both A2670 and A2630 with amendments passed the Assembly Floor on June 28, 2010. A2670, as amended, provides incentives to do business in New Jersey for surplus lines insurers and reinsurers that are financially sound. Among other things, the bill permits the Commissioner of Banking and Insurance in his discretion to **allow credit for reinsurance if the reinsurance is ceded to an assuming insurer that holds surplus or the equivalent in excess of $250 million**. A2630, as amended, seeks to create a regulatory and licensing scheme for captive insurers in the State.

New York Reinsurance Opinion. The office of General Counsel of the New York Insurance Department issued Opinion 10-03-02 (March 5, 2010) addressing two questions relating to the prior approval of reinsurance agreements. The first addressed whether "insurance in force," as used in New York Insurance Law § 1308(e)(1)(A), means all of the in-force policies issued by an insurer, or a sub-class thereof, such as in-force policies that are reinsured and cover risks located in New York. According to the Opinion, **"insurance in force" means all of the in-force policies issued by an insurer, regardless of whether the policies are reinsured or cover risks located in New York**. The second question, which was answered in the affirmative, addressed whether a property/casualty insurer should submit to the Superintendent of Insurance its proposed reinsurance agreement to reinsure all, or almost all, of its motor vehicle lessor/creditor gap insurance policies through an insurer that is not authorized to do an insurance business in New York.

Stop-Loss Insurance for Self-Funded Plans Deemed Reinsurance

BY BRIAN PERRYMAN

According to a Texas appellate court, **stop-loss insurance policies sold to self-funded employee benefits plans constitute reinsurance that is not subject to regulation** by the Texas Department of Insurance. In *American National Insurance Co. v. Texas Department of Insurance*, two insurance companies sought a declaratory judgment that they acted correctly by reporting stop-loss policies sold to self-funded plans as reinsurance instead of direct insurance. (The Department has no authority to regulate reinsurance, although it can and does regulate direct insurance.) The parties stipulated to the facts and filed cross-motions for summary judgment. The trial court granted the Department's motion, agreeing with the Department that self-funded plans are not insurers under Texas law.

The judgment was reversed on appeal. The appellate court examined the activities of the self-funded plans and found that, among other things, the plans make insurance contracts with the employees of the employer sponsors; collect premiums for their service from the plan sponsor or the employees or both; deliver insurance contracts to the employees; and provide expense indemnification, reimbursement, or direct payment of medical expenses to individuals. Consequently, **the court held that because such self-funded plans do many of the acts that constitute doing the business of insurance, such plans are insurers**.

Florida Okays Second Reinsurer For Reduced Collateral

BY ROLLIE GOSS

The Florida Office of Insurance Regulation (OIR) has approved XL Re Ltd. as the second non-Florida reinsurer to operate in Florida without having to post 100 percent collateral to support reinsurance credit taken by the ceding company. Hannover Re was the first reinsurer approved by Florida for reduced collateral transactions. These approvals were granted pursuant to Florida regulation 69O-144.007, which allows credit for reinsurance without full collateral for transactions involving reinsurers not domiciled in Florida, subject to certain requirements. The requirements include, among others:

- The reinsurer must obtain financial ratings from at least two approved rating agencies;
- The percentage of collateral required will be determined based upon the lowest rating;
- The reinsurer must consent to service of process and jurisdiction in Florida;
- The reinsurer and its regulator must provide periodic financial and other information to the OIR; and
- The reinsurer must hold surplus in excess of $100 million.

Treaty Tips: Know Your Arbitration Clause

BY ANTHONY CICCHETTI

After toiling to negotiate and document a reinsurance transaction, the parties may be inclined to spend less time with some of the so-called "boilerplate" provisions, such as those relating to arbitration. **Failing to devote sufficient thought to material provisions like the arbitration clause, however, can come back to haunt** because, as courts remind us, the **parties must live with their contract**.

Court found method for choosing ump clearly defined

At issue in *R.A. Wilson & Associates, Ltd. v. Certain Interest Underwriters at Lloyd's London* was a common provision for appointment of arbitrators: each party is to choose one "party arbitrator," with the two party arbitrators then appointing a third arbitrator to serve as umpire. The governing arbitration agreement further provided that if the two party arbitrators fail to agree on the umpire, either party could apply to a specified "appointer" (in this case, the President or Vice President of the Chartered Insurance Institute) to make the appointment. After a court compelled the parties to arbitrate a dispute, each appointed their arbitrator, but those appointees did not agree on the umpire. One of the parties then moved for a preliminary injunction to stop the selection of the umpire, arguing that ambiguity existed because the agreement did not specify the process that the party arbitrators or the appointer must use when appointing the umpire.

The U.S. District Court for the Eastern District of New York found that the arbitration agreement clearly defined the "method" for choosing the umpire. That it did not specify the underlying process meant that the party arbitrators and, as necessary, the appointer had discretion to use their professional judgment to decide on how to choose the umpire. The court refused to "circumvent the parties designation" of the appointer or to otherwise rewrite their agreement. The motion for preliminary injunction was denied sua sponte, leaving the parties to "follow the next step in the umpire selection process [which] is clear" – the parties will submit umpire candidates to the appointer, who will have the full authority granted to it under the agreement to make the final determination.

Unauthorized Reinsurer Can't Reduce Pre-Pleading Security Obligation

BY ANTHONY CICCHETTI

Under Connecticut law, an unauthorized insurer must generally post security before it may file pleadings in an action or proceeding brought against it. The amount of such security is to be determined by the court (or the insurance commissioner, as applicable in the matter) and must be "sufficient to secure the payment of any final judgment which may be rendered in the action or proceeding." In *Arrowood Surplus Lines Insurance Co. v. Gettysburg National Indemnity Co.*, the U.S. District Court for the District of Connecticut held that the governing statute requires that the security cover the full amount of the plaintiffs' claims, regardless of whether the unauthorized insurer – here a reinsurer contesting payment obligations under two treaties – might have a legal basis for arguing that its ultimate liability would be limited to a lesser amount.

The cedent in this case had alleged that the reinsurer failed to pay $660,389 under the treaties at issue. After a hearing on the cedent's motion for pre-pleading security, the Magistrate Judge ruled that the reinsurer must post security in that amount. Objecting to the ruling, the reinsurer argued that the cedent was contractually precluded from seeking recovery beyond the significantly lesser amount then held in the segregated accounts relating to the treaties. Reasoning that the cedent, if it prevails, may be awarded the full amount it seeks, the District Court concluded that the statute was plain in requiring that **pre-pleading security be posted in an amount necessary to satisfy a possible judgment**. The court (applying a "not clearly erroneous or contrary to law" standard) accordingly overruled the reinsurer's objection. It stated, however, that **the reinsurer would not be precluded from arguing later in the case that its liability should be limited as it claimed**.

Implementation of Dodd-Frank Act

New York Publicizes Draft Amendments To Credit For Reinsurance Regs

BY ANTHONY CICCHETTI

Evidently constituting **one of the first state insurance department actions (if not the first) responding to the Nonadmitted and Reinsurance Reform provisions of the Dodd-Frank Act** (DFA), New York recently issued for comment draft proposed amendments to its regulations governing credit for reinsurance. New York's latest draft generally carries forward its earlier proposal, which, among other things, addressed the perceived inequality in collateral requirements for non-U.S. reinsurers through a ratings-based framework for collateral determinations. Notably, however, several changes now embodied in New York's proposal appear to respond directly to DFA.

For example, whereas it previously aimed to reach "authorized insurers," New York under this draft amendment would **expressly exclude** from the provision's reach transactions where the cedent's state of domicile (other than New York) recognizes credit for the ceded risk and is an NAIC-accredited state, or has financial solvency requirements substantially similar to the requirements for NAIC accreditation. In addition, with regard to the law that may govern a reinsurance contract, New York's proposal now states that **the reinsurance contract must provide that disputes thereunder be governed by and construed in accordance with one of three options**: (1) the laws of New York, (2) the laws of the cedent's domicile, or (3) the laws of any state chosen by the cedent. Again apparently acknowledging DFA, New York's draft proposal expressly provides that an **agreement by the parties to arbitrate disputes is not overridden** by such governing law provisions.

Absent further initiative by the NAIC to advance its previous proposal to "modernize" reinsurance regulation as it relates to collateral requirements, New York's approach, if it becomes effective, could represent another piece in a patchwork whereby various states adopt their own modified collateral requirements within the parameters of DFA, while others maintain the status quo.

Dodd-Frank Harmonizes New Tune for Broker-Dealers

BY MARILYN SPONZO

The regulatory crusade to "harmonize" the standards of care that broker-dealers and investment advisers owe their retail clients advanced significantly with the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act. DFA not only directs the SEC to conduct a six-month study, followed by a report to Congress, evaluating the current standards of care applicable to broker-dealers and investment advisers, but also grants the SEC authority to promulgate rules imposing a fiduciary standard on broker-dealers. The potential effects of a fiduciary standard on broker-dealers include:

Regulators to broker-dealers: Be careful what you croon to clients

- Expansion of risks and potential liabilities, as broker-dealers move from observing "high standards of commercial honor and just and equitable principles of trade" to acting **"in the best interest of the customer without regard to the financial or other interest"** of the broker-dealer;
- Increased **point-of-sale disclosure**, including the broker-dealer's: (i) relationship to the issuer, underwriter and other distribution entities; (ii) sources of compensation; and (iii) conflicts of interest, particularly with respect to distribution relationships and compensation arrangements;
- Continuous **monitoring of conflicts of interest**, along with heightened review of, and possible restrictions on, associated persons' outside business activities to reduce conflicts;
- Heightened suitability standards and documentation for recommendations that, rather than simply being "reasonable," would have to be **"in the client's best interest"**;
- More emphasis on best execution;
- More stringent hiring standards and disclosure of disciplinary histories;
- Revision of customer account agreements, and potential new documentation for existing client accounts; and
- **Enhanced supervisory systems and internal controls**, supported by appropriate training.

Additionally, DFA requires the SEC's study to evaluate the consequences of eliminating the current broker-dealer exemption from the definition of investment adviser under the Investment Advisers Act of 1940. Imposition of all Advisers Act requirements on broker-dealers could significantly affect almost all aspects of their activities that are subject to SEC regulation.

Finally, DFA directs the U.S. Comptroller General to submit, within 180 days after enactment, a report to Congress evaluating state and federal oversight and regulation of financial planners. Although DFA does not define the term "financial planner," the context suggests it applies to insurance agents, registered representatives, investment advisers and others who provide advice regarding the management of financial resources. Without question, the recommendations of the Comptroller General's report could significantly impact broker-dealer activities.

New Whistleblower Provisions Extend to Mutual Funds

BY KAREN BENSON

Do the whistleblower provisions in the Sarbanes-Oxley Act apply to employees of mutual fund advisers? In two closely-watched cases brought by former employees of Fidelity Investments, a federal judge in the U.S. District Court for the District of Massachusetts found that they do apply, but, after ruling against Fidelity on the issue, later granted Fidelity's motion to have the issue certified for interlocutory appeal to the First Circuit. While the appeals court has yet to rule on the issue, new whistleblower provisions under the Dodd-Frank Act (DFA) will cover employees of mutual fund advisers, regardless of whether the adviser is a public company or privately held.

DFA creates **financial incentives for whistleblowers who report violations of securities laws** to the SEC. Under the new provisions, if original information voluntarily provided to the SEC by one or more whistleblowers results in monetary sanctions exceeding $1 million, the SEC must, if certain conditions are met, award the whistleblowers between 10% and 30% of the sanctions. Claims for awards to the SEC may be made anonymously if the whistleblower is represented by counsel and the whistleblower's identity and other information required by the SEC is disclosed before payment of an award.

Moreover, DFA includes anti-retaliation protections for securities whistleblowers. Employers may not discharge, demote, suspend, threaten, harass or discriminate against a whistleblower. **Whistleblowers who suffer from employment retaliation may sue in U.S. District Court for reinstatement, double back pay with interest, and litigation costs and reasonable attorneys' fees.** These protections may not be waived by an agreement or condition of employment, including by a predispute arbitration agreement.

The SEC has until April 17, 2011 to issue final regulations implementing the whistleblower provisions and is in the process of preparing a rule proposal. Meanwhile, the SEC is seeking input from the public prior to commencing the formal rulemaking process.

SEC Proposes New Framework to Replace Rule 12b-1

BY CHIP LUNDE

On July 21, 2010, the SEC unanimously voted to propose a new rule and various rule amendments that would replace Rule 12b-1 with a new framework governing how mutual funds may use their assets to pay for sales and distribution expenses. The new framework would:

- Eliminate Rule 12b-1 and related disclosure and fund board obligations,
- Differentiate between the two ways 12b-1 fees currently function in terms of "ongoing sales charges" and "marketing and servicing fees,"
- Cap the amount of cumulative sales load, including ongoing sales charges, that a fund investor may pay over time. The total could not exceed the amount of the front-end load imposed by a fund. If the fund does not have a share class with a front-end load, the total could not exceed the sales load limit under NASD Rule 2830,
- Limit the amount of marketing and servicing fees that may be deducted from fund assets in accordance with NASD limits on service fees (currently 25 basis points per year),
- Require fund confirmation statements to include sales load disclosure, and
- Provide an exemption to allow funds to create a new class of shares that will permit financial intermediaries to charge sales loads at negotiated rates.

Although it is still early in the rulemaking process, funds with 12b-1 plans and recipients of 12b-1 fees nevertheless may find it prudent to revisit their revenue sharing and other arrangements to assess the potential impact of the proposed changes.

Regulators Required to Scrutinize Compensation Arrangements

BY ED ZAHAREWICZ & SARAH JARVIS

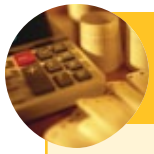
Tucked away among the several executive compensation-related provisions of the Dodd-Frank Act is one **directing Federal regulators to jointly prescribe regulations or guidelines** that will require "covered financial institutions," including investment advisers and broker-dealers, to disclose to "the appropriate Federal regulator" **the structure of all incentive–based compensation arrangements** offered by such institutions. The disclosure must be sufficient for the regulators to determine whether the arrangement:

- Provides an executive officer, employee, director, or principal shareholder of the institution with "excessive compensation, fees, or benefits;" or
- Could lead to material financial loss to the institution.

Additionally, the appropriate Federal regulators must jointly prescribe regulations or guidelines prohibiting any such arrangement, or any feature of such an arrangement, that the regulators determine "encourages inappropriate risks" by covered financial institutions.

Federally insured depository institutions have been subject to similar regulation for more than 15 years. Indeed, the Act requires Federal regulators to ensure that any standards for compensation they establish be comparable to the standards established under the Federal Deposit Insurance Act for insured depository institutions.

Covered financial institutions with assets of less than $1 billion are exempted from the new requirements. Federal regulators have until to April 21, 2011 to complete the required rulemaking.



Scribner, Hall & Thompson, LLP

New I.R.C. § 162(m)(6) Surprises Many Insurance Companies

BY JANEL C. FRANK

I.R.C. § 162(m)(6), adopted as part of the Patient Protection and Affordable Care Act (Pub. L. No. 111-148), added a new wrinkle to the compensation deduction limitation under section 162(m) for compensation paid by health insurance companies, whether or not publicly traded. I.R.C. § 162(m) had limited the deduction for compensation (other than performance-based compensation) paid to certain highly compensated officers and employees of publicly traded companies to $1,000,000 in a taxable year. For "health insurance companies," the new limitation applies to all compensation (including performance-based compensation) in excess of $500,000 paid to any officer, director, employee, or service provider after December 31, 2012. To be subject to the deduction limitation, the insurance company must receive at least 25% of its gross premiums for health insurance coverage from what qualifies as "minimum essential coverage." Minimum essential coverage is coverage for hospital and medical care but does not include coverage for accident, disability income, and liability insurance or stand-alone policies for dental, vision, and nursing home care. The surprise for some insurance companies is that **the 25%-of-gross-premium test does not relate to premium from all coverage**, just health insurance coverage. If a company has a single health insurance contract that provides for hospital and medical care, which represents less than 1% of its total business, the insurer can be subject to the new I.R.C. § 162(m)(6) limitation. As yet, there is no de minimis exception.

For deferred compensation, the section 162(m)(6) limitation applies to compensation that was earned after December 31, 2009, and paid after December 31, 2012. The amount of deferred compensation that is subject to the limitation relates back to and is computed based upon the year the deferred compensation was earned. For example, if a covered individual received $400,000 in deductible wages and earned $200,000 in deferred compensation in 2010, the amount of deferred compensation that may be deducted in 2013, when paid, would be $100,000 ($500,000 - $400,000) regardless of other compensation paid in 2013. **Deferred compensation is subject to 162(m)(6) if the insurance company received any amount of premiums from health insurance coverage.** Again, because there is no de minimis exception, all deferred compensation that is earned after December 31, 2009, and not paid before January 1, 2013, may be swept under the new rule. Surprise!

Congress Flip Flops on New SEC FOIA Exemption

BY RICHARD CHOI

Only weeks after Congressional passage of a new SEC exemption from the Freedom of Information Act (FOIA), members of both the House and Senate have introduced legislation that would repeal the very same exemption.

The new FOIA exemption, included in Section 929I of the Dodd-Frank Act, excuses the SEC from disclosing: (1) records or information it receives under the Exchange Act, Investment Company Act, or Advisers Act, and (2) records or information based upon or derived from such records or information, if the SEC obtains such records or information for use in furthering the purposes of those statutes, "including surveillance, risk assessments, or other regulatory and oversight activities."

Critics of the exemption argue that it is contrary to the goal of greater transparency and that its broad language gives the SEC **"blanket authority" to reject FOIA requests** for records pertaining to regulated entities.

In July 30, 2010, letters to both Senator Christopher Dodd and Representative Barney Frank, SEC Chairman Mary Schapiro defended Section 929I on grounds that it "is critical to our ability to develop a robust examination program that better protects investors" and "will allow the SEC to gain access in a timely fashion to information and data that it otherwise may not receive, thereby further enhancing our ability to identify fraud and root out wrongdoing." Schapiro rejected the assertion that the exemption provides a "blanket SEC exemption from FOIA." At the same time, she stated that to address "any uncertainty" about how the SEC will use the exemption, the SEC would issue guidance to its staff "that ensures that the provision is used only as it was intended."

On August 3, 2010, SEC Administrative Law Judge James Kelly denied an attempt by the SEC's Office of Compliance Inspections and Examinations to claim retroactive protection of Section 929I to resist producing documents in response to an administrative subpoena issued before the enactment of Section 929I.

Representative Frank, Chair of the House Financial Services, **announced that his Committee will hold hearings on whether to narrow the scope of the exemption in September**.

New Recordkeeping Requirements for Private Fund Advisers

BY SCOTT SHINE

The Dodd-Frank Act (DFA), among other things, eliminates the private adviser exemption and raises the threshold amount of asset under management that an adviser must have to register with the SEC. As a result, advisers to private funds with $100 million or more in assets will generally be subject to SEC registration requirements unless another exemption is available. Once registered, private fund advisers will be required to comply with all applicable provisions of the Advisers Act. In addition, they will face **several new recordkeeping and reporting requirements** designed specifically for such advisers.

DFA directs the SEC to promulgate rules within 12 months of its enactment (i.e., by July 21, 2011) that will require advisers to private funds to maintain the following information for each private fund it advises:

- the amount of assets under management and use of leverage, including off-balance-sheet leverage;
- counterparty credit risk exposure;
- trading and investment positions and practices;
- valuation policies, practices and types of assets of the fund;
- side arrangements whereby certain investors in a fund obtain more favorable rights or entitlements than others;
- other information the SEC determines is necessary to assess systemic risk. DFA directs the SEC to make this determination in consultation with the newly created Financial Stability Oversight Council which will be comprised of 14 heads of agencies and tasked with monitoring systemic risk. The information requested may differ based on the type or size of the fund.

Advisers to private funds will also be required to file reports with the SEC containing any information the SEC deems necessary and appropriate for the protection of investors or for the assessment of systemic risk. DFA directs the SEC to conduct periodic inspections of the these records in accordance with an established schedule. The SEC may also, in its discretion, conduct additional examinations at any time it deems it necessary.

Furthermore, DFA will require all advisers, including private fund advisers, with investment discretion over $100 million of equity in U.S. public **companies to provide monthly disclosures of the aggregate amount of the number of short sales of each security and to report at least annually how they vote on any say-on-pay proposal related to any U.S. public company**.

Dodd-Frank Boosts State Securities Regulators

BY TOM LAUERMAN

The Dodd-Frank Wall Street Reform and Consumer Protection Act undoubtedly ranks as one of the greatest expansions of federal regulatory (including SEC) power in history. DFA also, however, substantially increases the role of state securities regulators.

Most significantly, under DFA, **certain advisers with less than $100 million of assets under management will no longer be subject to SEC registration**. This will substantially increase the role of the states in regulating such advisers.

Private offerings of securities pursuant to the SEC's Regulation D are generally exempt from state securities registration (qualification) requirements. **DFA, however, provides for higher standards to qualify as an "accredited investor" in Regulation D offerings and also will prohibit "bad actors"** (i.e., persons subject to certain convictions or regulatory sanctions) **from making such offerings**. Some offerings that, because of these changes, can no longer be made pursuant to Regulation D may consequently need to be registered, or satisfy an exemption, under applicable state securities laws.

In addition to such additional direct regulatory functions, state securities commissioners will have a representative on a new SEC Investor Advisory Committee that will be created pursuant to DFA. Membership on this influential committee will greatly enhance the state regulators' ability to influence the SEC's policies and positions.

In what for them will be an even less familiar role, state securities commissioners also will have a seat at the table in DFA's new arrangements for regulation of systemic risks. Specifically, such securities commissioners will establish a procedure to select one among them to serve as a non-voting member of the new Financial Stability Oversight Council. The council, of course, will be a key player in systemic regulation.

Dodd-Frank "Dis-Accredits" Investors

BY SCOTT SHINE & TOM LAUERMAN

The Dodd-Frank Wall Street Reform and Consumer Protection Act mandates a **tougher net worth test for determining "accredited investor"** status pursuant to Regulation D and Rule 215 under the Securities Act of 1933. Specifically, the SEC must modify its rules so that, effective July 21, 2014, the current $1,000,000 net worth threshold for natural persons will be such higher amount as the SEC shall determine.

Moreover, DFA imposes a new requirement that **the value of a natural person's primary residence must be excluded from calculating whether that person meets any net worth test** in the accredited investor definition. The SEC staff interprets this exclusion of the primary residence to apply immediately without any further SEC action to amend its rules. This immediately-effective change is consequential in light of, among other things, the heightened disclosure requirements that are applicable to private offerings under Regulation D that include unaccredited investors. The change would apply not only to new offerings under Regulation D, but also to offerings that are already ongoing, including new investments by previous purchasers.

Some investors will have to seek a different catch

The SEC staff has stated that indebtedness secured by the principal residence also may be excluded from the net worth calculation, to the extent such indebtedness does not exceed the current fair market value of the residence. However, the amount of any such indebtedness in excess of the fair market value of the residence must be counted in the net worth computation.

The SEC also may review and change other aspects of its definition of accredited investor before July 21, 2014. Thereafter, DFA requires the SEC to review the definition in its entirety at least every four years, as it applies to natural persons, although the SEC is not necessarily required to take any action as a result of such reviews.

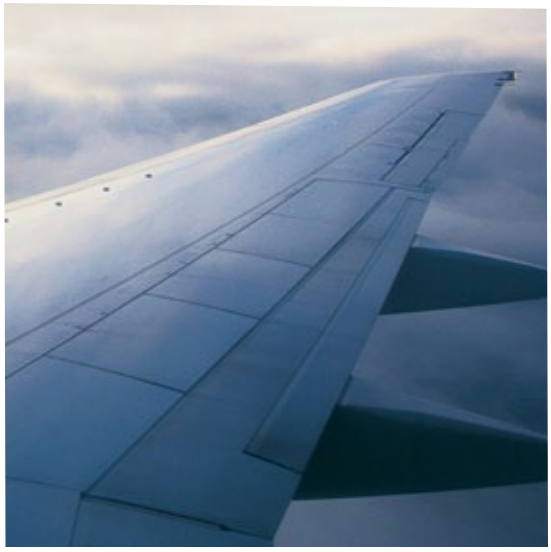
SECURITIES

New Nationwide Subpoena Powers

BY STEPHAN VOUDRIS

The recently-enacted Dodd-Frank Wall Street Reform and Consumer Protection Act, gives nationwide **subpoena powers to both the SEC and defendants in any federal court action instituted by the SEC** under the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, or the Investment Advisers Act of 1940. Effective immediately, **any such party can serve subpoenas** requiring the attendance of witnesses or production of documents at a hearing or trial **anywhere within the United States**.

This is one of several DFA reforms that will make the SEC's enforcement program substantially more formidable. In the past, nationwide service of subpoenas on witnesses has been inhibited by a federal procedural rule that normally precludes subpoenas from requiring nonparties to travel more than 100 miles from where that person resides, is employed, or regularly transacting business (unless the person is within the same state as the trial), as well as by the typical practice of producing documents where they are kept. For example, at trial or hearings, parties often have been forced to use deposition testimony for out-of-state witnesses, particularly uncooperative ones.



Travel to distant proceedings may now be compelled in some cases

White Collar Defense & Appeals

Supreme Court Busy With Honest-Services

BY RICHARD SHARPSTEIN, SCOTT BYERS & ARI GERSTEIN

The Supreme Court recently issued two major decisions that may completely remake the boundaries of federal law enforcement. As the corporate frauds of the early 21st century unfolded, prosecutors increasingly turned to the "honest-services" mail fraud statute, originally intended for prosecution of public officials, to criminally prosecute executives for questionable business decisions that never actually involved the taking of any money or property from a victim. Over the past decade, **federal prosecutors have employed this statute to charge executives or other employees of having defrauded their company, shareholders or the public**. The statute ensnarled many high level executives, including ex-HealthSouth CEO Richard Scrushy and several Enron executives. The statute's increasing use attracted critics including Supreme Court **Justice Antonin Scalia, who suggested that the statute "would seemingly cover a salaried employee's phoning in sick to go to a ball game."** With former Enron CEO Jeffrey Skilling's appeal, however, the statute has been grounded.

In *Skilling v. U.S.*, the Supreme Court overturned Skilling's honest-services mail fraud conviction, **holding that the statute may only be used to prosecute bribery and kickback schemes**. Moreover, the Court explained that allowing the statute to be applied outside the context of a party accepting side payments from a third party in exchange for fraudulent conduct would render the statue unconstitutional. The Court overturned Skilling's conviction because the government failed to allege that Skilling ever accepted payments from a third party in exchange for his misrepresentations.

On the same day as *Skilling*, the Court then remanded the appeal of media tycoon Conrad Black and other Hollinger International executives in *Black v. U.S.* back to the Court of Appeals based on faulty jury instructions that allowed the jury to convict the defendants under the honest-services theory rejected in Skilling.

Caution: SEC Delays Ahead

BY ANN FURMAN

With our new and improved financial regulatory system currently under construction, registrants may soon experience delays in the SEC's processing of disclosure filings, as well as requests for exemptions, no-action letters, and interpretive advice.

For the indeterminate future, the SEC and its staff will be required to devote an enormous amount of time and attention to their assigned responsibilities under the Dodd-Frank Wall Street Reform and Consumer Protection Act. These include:

- Researching and writing studies and making reports on such matters as standard of care for broker-dealers and investment advisers, enhanced examinations of investment advisers, mutual fund marketing, and financial literacy;
- Researching, writing and adopting new regulations covering matters such as advisers to hedge funds, security-based swaps, and pre-dispute arbitration;
- Responding to studies, even if the SEC is not itself conducting those studies;
- Creating new SEC offices and programs, such as an Office of the Investor Advocate;
- Hiring and training employees to fill hundreds of new positions; and
- Conducting relations with other governmental and regulatory bodies.

Clock watching will not make SEC processing happen more quickly

The SEC has wasted no time in seeking public input. For example, on July 27, the SEC issued a release seeking comment on each component of its mandated report to Congress on standards of care for broker-dealers, investment advisers and associated persons. Then, on July 30, 2010, the SEC invited comments on a long list of DFA initiatives "even before official comment periods may be opened."

DFA provides the SEC with financial resources to increase its personnel. As with any new hire (not to mention the 800 new hires that SEC Chairman Schapiro has stated will be necessary), however, it takes time to get up-to-speed. **The sheer scope of the SEC's report writing and rulemaking obligations are bound to impose a significant workload strain on the agency** and dictate its agenda for the foreseeable future.

So, what will be the practical effect on SEC registrants? Anticipate delays and hope for the best.

Mark Your Calendars

Diane Duhaime, Partner in the Connecticut office, will be speaking at the 2nd Annual Connecticut Privacy Forum, September 23, 2010, at the Hartford/Windsor Marriott. Her presentation is on Social Media - Privacy and Security. For more information, visit *www.ctprivacy.com*.

Consumer Fraud Class Actions Not Per Se Inappropriate in Seventh Circuit

BY MICHAEL SHUE

In *Pella Corp. v. Saltzman*, the Seventh Circuit affirmed the certification of multiple classes against window manufacturer Pella and further clouded the issue of whether consumer fraud cases are fit for class certification. Plaintiffs brought a putative class action alleging that a design defect in the windows caused water damage, and that Pella's failure to acknowledge that the design defect caused the water damage constituted consumer fraud. The district court certified one Rule 23(b)(2) nationwide class comprised of people with defective windows that either had not yet caused damages or had not yet been replaced, and six Rule 23(b)(3) statewide classes comprising people who had already replaced their defective windows.

The Seventh Circuit may have made things a little more confusing

The Rule 23(b)(3) classes were certified on the question of liability only, the district court explicitly declining to certify issues related to causation, damages, and statute of limitations. Pella sought interlocutory review under Rule 23(f), and argued that consumer fraud cases are not suitable for class certification due to individualized issues such as causation, reliance, and damages. While the **Seventh Circuit conceded that consumer fraud class actions present special difficulties, such as proving proximate causation, it held that proximate cause "is necessarily an individual issue and the need for individual proof alone does not necessarily preclude class certification**." The court concluded that "a district court has the discretion to split a case by **certifying a class for some issues, but not others, or by certifying a class for liability** alone where damages or causation may require individualized assessments." The court's ruling acknowledged that consumer fraud class actions "present problems that courts must carefully consider," but dispelled the idea that Seventh Circuit precedent mandated that "class certification was never appropriate in consumer fraud cases."

Intellectual Property & Technology Update

Business Methods Remain Patentable After U.S. Supreme Court Decision in *Bilski*

BY DIANE DUHAIME & LIAM BURKE

On June 28, 2010, the Supreme Court unanimously affirmed the decision of the Federal Circuit in *Bilski v. Kappos*. While the Justices were unanimous in their judgment, they were split 5-4 on their reasoning. Justice Kennedy authored the majority opinion.

In this closely-watched case, the Court resolved the patent eligibility issue on narrow grounds—holding that the Federal Circuit's machine-or-transformation test is not the exclusive test that should be used to determine whether a process is patentable under the Patent Act. The Court held that the "machine-or-transformation test is a useful and important clue, an investigative tool … [but it] is not the sole test for deciding whether an invention is a patent-eligible 'process.'"

Many commentators were disappointed that the Court did not provide a clear definition of what constitutes a patentable process. Indeed, Justice Stevens' lengthy concurrence (joined by three other justices) opines that the majority ought to have affirmed the Federal Circuit's decision because business methods are not patentable.

The Court's opinion leaves the lower courts open to formulate more flexible approaches when determining whether a business method is a patent-eligible process. Since the Bilski decision did not close the door on the patentability of business methods, and did not provide a clear definition of what constitutes a patentable process, **the patentability of business methods is an issue that will continue to be litigated** in the near and foreseeable future.

Jorden Burt has tracked the developments of this case in *Expect Focus*, Volume I, Winter 2009, p. 13, and *Expect Focus*, Volume III, Summer 2009, p. 13.

Ninth Circuit Approves Class of Twenty Members

BY ANDRES CHAGUI

Noting that it constituted a "jurisprudential rarity," the Ninth Circuit nonetheless upheld certification of a class of twenty members. In *Rannis v. Recchia*, plaintiffs alleged that the defendant California attorney had violated the Credit Repair Organizations Act by accepting payment in advance of the provision of services and failing to provide required disclosures. The district court granted the motion to certify a class consisting of 74 potential members and the defendant subsequently filed a motion to decertify the class on numerosity grounds. In assessing defendant's motion to decertify the class, the district court determined that the proposed class actually consisted of just 20 members. Notwithstanding the small class size, the district court denied defendant's motion to decertify the class.

In affirming the lower court's ruling, the **Ninth Circuit explained that the numerosity requirement "is not tied to any fixed numerical threshold" but instead requires the court to examine the specific facts** of each case. Here, the district court had found that judicial economy weighed in favor of maintaining the class structure because **decertification would be inefficient, "clogging" the district court with individual suits, and costly** for class members, whose damages were unlikely to exceed $600. Moreover, **decertification could confuse those class members who had already been notified about the settlement award**. For these reasons, the Ninth Circuit held that the district court did not abuse its discretion in determining that a class of 20 individuals satisfies the numerosity requirement of Rule 23(a), noting that other circuits have upheld class certifications involving classes of 18 or 20 members and that district courts have "broad leeway in making certification decisions."

Ninth Circuit: Numerosity "is not tied to any numerical threshold"

CAFA Appeals Must Comply With Rules For Permissive Appeals

BY KIM FREEDMAN

Ruling on a case removed to federal district court pursuant to the Class Action Fairness Act (CAFA), the Eighth Circuit denied plaintiffs' request for permission to appeal the district court's refusal to remand the case to state court and recognized what other circuits have consistently held: that the CAFA provision addressing review of remand orders provides for a discretionary appeal and, therefore, requires all such appeals to comply with Federal Rule of Appellate Procedure 5, which sets forth the requirements for permissive appeals. In *Froud v. Anadarko E&P Company Limited Partnership*, the court, "expressly adopt[ing]" this standard as the law of the Eighth Circuit, then applied FRAP 5 to plaintiffs' petition for permission to appeal.

Under FRAP 5, **a petition for permission to appeal must include the facts necessary to understand the question presented, the question itself, the relief sought, and the reasons why the appeal should be allowed**. Applying this rule, the Eighth Circuit observed that plaintiffs' petition failed to give any reason why the appeal should be allowed and that the petitioners provided no discussion of the merits or the nature or importance of the issues presented. Accordingly, the court held that the petitioners failed to provide it with a basis on which to exercise its discretion to permit an appeal under FRAP 5, and therefore denied the petition for permission to appeal.

Arbitration Roundup

BY LANDON CLAYMAN

In a 5-4 ruling, the U.S. Supreme Court held that an "unconscionability" challenge to the entirety of a stand-alone arbitration agreement was for the arbitrator to decide, though a challenge limited to the agreement's "delegation provision," expressly assigning to the arbitrator the "gateway" question of the enforceability of the agreement, may well have been for the district court to decide in *Rent-A-Center, West, Inc. v. Jackson*. Because the plaintiff had attacked the entire agreement, rather than the "delegation" or other provision of the agreement, the Court held the case was governed by the *Prima Paint* doctrine, under which arbitrators decide challenges to the validity of entire agreements, rather than to the arbitration provisions within the agreements.

The Third Circuit's en banc opinion in *Puleo v. Chase Bank USA, N.A*, ruled that a challenge by credit cardholders to the enforceability of a class action waiver in an arbitration provision within the bank's cardmember agreement presented a question of arbitrability for the court – not the arbitrator – to decide. The district court had ordered arbitration of the individual claims, rejecting plaintiffs' request that the court order the parties to submit the class claims to arbitration and allow for the arbitrator to decide whether the class action waiver was unconscionable and therefore unenforceable, and the Third Circuit affirmed..

Here's the idea: Say it plainly in the arbitration agreement

The issue on appeal was simply "who decides whether the class action waiver is unconscionable?" The Third Circuit agreed with other circuit courts that, unless the parties have clearly and unmistakably provided otherwise, an unconscionability challenge to a provision of an arbitration agreement is a question of arbitrability for the court, not the arbitrator, to decide. Thus, plaintiffs' challenge to the class action waiver in the Chase arbitration agreement did not belong in arbitration.

Although challenges to provisions of an arbitration agreement claiming that such provisions are unconscionable go to the validity of the agreement to arbitrate and therefore are generally for the courts to decide, a prudent, cautious drafter might expressly provide in the arbitration agreement that issues of arbitrability, including unconscionability challenges to provisions of the agreement, will not be arbitrated, but may be decided only by the court.

CAFA Jurisdiction Unaffected By Denial of Class Certification

BY FARROKH JHABVALA

The Seventh Circuit recently reiterated in a CAFA removal case **the well-established rule that jurisdiction is determined at the time of removal and "nothing filed after removal affects jurisdiction."** In *In re Burlington Northern Santa Fe Railway Company*, the plaintiffs sued the railway company in Wisconsin state court alleging that the company's failure to inspect and maintain a railroad trestle caused their town to flood in July 2007, damaging their property. The company removed the case to federal court under the Class Action Fairness Act, and the parties thereafter engaged in an extensive battle over jurisdiction. **After the district court denied plaintiffs' motion to remand** the case to state court, the **plaintiffs sought leave to amend the complaint by omitting** their class allegations. The district court permitted the amendment, construed plaintiffs' motion as one for an implied remand, and granted remand.

The Seventh Circuit granted the petition, or appeal and **reversed the district court's remand decision**, explaining that while it may be possible for a plaintiff who sues in federal court "to amend away jurisdiction," removal cases present concerns regarding forum manipulation that caution against allowing a plaintiff's post-removal amendment to affect jurisdiction. It concluded that **"CAFA jurisdiction attaches when a case is filed as a class action, and that even if the class is not certified, jurisdiction continues."**

New DOL Retirement Plan Fee Disclosure Regulation to Take Effect in 2011

BY JOHN PITBLADO

The U.S. Department of Labor's Employee Benefits Security Administration published an **interim final rule addressing new disclosure requirements pertaining to employee benefit plans**, particularly retirement plans. The rule, published in the Federal Register for comment on July 16, 2010, incorporates extensive public comments received to previously published versions of the rule from affected parties, including representatives of retirement plan participants, sponsors, named fiduciaries, and service providers that administer such plans. The rule is proposed to be implemented as a clarification to the current applicable regulation, in defining **what constitutes "reasonable" compensation to service providers** retained by plan sponsors to administer employee benefit plans. The new rule pertains to both defined contribution and defined benefit plans, but reserves for future regulation any disclosure requirements pertaining to employee welfare plans.

Generally, **the rule is intended to clarify the disclosure requirements for service providers pertaining to the fees charged to plan sponsors** as part of the overall regulatory scheme intended to ensure that plan sponsors and fiduciaries are able to make informed decisions for the benefit of plan participants. The rule focuses on the substance of the written disclosures, and removes the requirement of a formal written contract delineating disclosure obligations between service providers and plan sponsors. It **also broadens the definition of "service providers" to encompass any providers of services that receive payment** or indirect compensation from affiliates and requires service providers to separately disclose the costs of record-keeping services. The comment period ended August 30, 2010, and the rule is proposed to take effect July 16, 2011.

Emerging Trend: Stranger-Originated Annuity Transactions and Accompanying Litigation

BY SCOTT SHINE

The insurance industry and its regulators have been taking steps to respond to the emergence of stranger-originated annuity transactions (STATs) and stranger-originated life insurance policies (STOLIs). In a May hearing, the NAIC discussed the legality of the transactions under current laws and actions that could be taken by both the industry and by regulators to prevent the practice.

An area of debate at the NAIC hearing and in recent litigation has been **whether insurable interest laws, which prohibit STOLIs, can apply to STATs** even though insurable interest laws generally apply specifically to life insurance policies, and not necessarily annuities. Insurance companies engaged in STAT and STOLI litigation have attempted to use the insurable interest laws to challenge the validity of the contract or policy. In states where the courts have determined that insurable interest laws apply only to insurance and therefore not to STATs, companies have sought to evoke the termination clause on the grounds that the lack of disclosure regarding the relationship between the annuitant and the owner makes the contract materially misleading, incomplete or deficient.

In an effort to prohibit STATs and clarify the legal uncertainty surrounding them, **states are beginning to issue guidance on how companies can identify STATs prior to issuing the contract**. Ohio was the first state to issue such guidance in 2009 and Louisiana recently followed suit in July 2010. Furthermore, the NAIC and individual states are discussing whether new or modified regulations are necessary to better protect investors.

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SOUTHEAST
Suite 500
777 Brickell Avenue
Miami, FL 33131–2803
305.371.2600
Fax: 305.372.9928

WASHINGTON, D.C.
Suite 400 East
1025 Thomas Jefferson St., N.W.
Washington, D.C. 20007–5208
202.965.8100
Fax: 202.965.8104

NORTHEAST
Suite 301
175 Powder Forest Drive
Simsbury, CT 06089–9658
860.392.5000
Fax: 860.392.5058