EXPECTFOCUS®

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Regulatory Updates in 2009

Cutting through or creating red tape?

JORDEN BURT LLP

EXPECT**FOCUS**™® Vol. I Winter 2009

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

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Moira Demyan
mfd@jordenusa.com

INTHE**SPOTLIGHT**

Spotlight on 151A

BY GARY COHEN

The focus of the fight over Rule 151A has shifted from the SEC to the courts.

A group of insurers filed a lawsuit against the SEC asking the Court of Appeals for the District of Columbia to hold the Rule unlawful. The group includes the American Equity Investment Life Insurance Company, BHC Marketing, Midland National Life Insurance Company, National Western Life Insurance Company, OM Financial Life Insurance Company, and Tucker Advisory Group, Inc.

Subsequently, the National Association of Insurance Commissioners (NAIC) and the National Conference of Insurance Legislators (NCOIL) filed a similar lawsuit, and AARP joined the coalition's lawsuit.

The parties filed briefs with the court on February 17, 2009. Oral arguments are set for May 8, 2009.

The insurers argued as follows. Index annuities are exempt from regulation as securities, because they "are subject without exception to state [insurance] laws" and "are not marketed or valued according to the investment management of the issuer." The "terms of Rule 151A conflict with the Supreme Court's decisions [in VALIC and United Benefit] and the statutory text [of Section 3(a)(8) of the Securities Act]." The Rule's "invalid terms result from the Commission's use of a definition of investment risk that conflicts with the governing caselaw and common parlance."

The NAIC and NCOIL argue as follows. The SEC ignored the McCarran-Ferguson Act that commits insurance regulation to the states. Rule 151A is "arbitrary, capricious and contrary to law." The SEC failed to consider evidence that there was no "widespread abuse and complaints." The SEC did not consider the protections already provided by the state regulatory system. The SEC failed to engage in the required analysis of "the inefficiencies created by a dual regulatory system."

The insurer's brief notes that Commissioner Troy A. Paredes dissented from the SEC's adoption of the Rule. As Commissioner Paredes requested, his dissent is set out in the Federal Register along with the SEC's adopting release.

With the Rule not effective until January 12, 2011, there seems to be time for the court to consider the lawsuits challenging the Rule. Nevertheless, the insurers asked the court for, and received, an expedited briefing schedule.

Despite the lawsuits, the SEC staff has indicated that it intends to push ahead with implementing the Rule. The staff has further indicated that it will begin work on tailoring disclosure and accounting requirements to fit index annuities.

For further Rule 151A coverage, please see *Uncertain Times for Index Annuities* on page 12.

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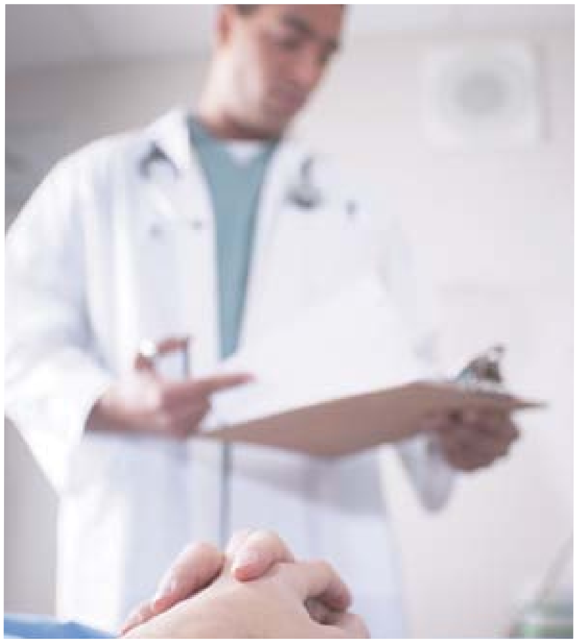
Insurer Prevails in Bipolar Disorder Classification

BY ROBIN SANDERS



On December 23, 2008, the U.S. District Court for the District of New Jersey determined that bipolar disorder was reasonably considered a "Mental Illness" under the ERISA-governed long-term disability policy at issue. The plaintiff in *Doe v. Hartford Life and Accident Insurance Company* brought suit individually and on behalf of a putative class, alleging that Hartford improperly terminated his long-term disability benefits after 24 months because bipolar disorder is not a "Mental Illness," as that term was defined in his policy. Plaintiff's allegations were based on his treating psychiatrist's opinion that bipolar disorder is a "biological illness."

In upholding the defendant's benefits determination as being reasonable, the court applied a deferential abuse of discretion standard of review. In doing so, the court examined whether the deference given to the defendant should be altered based on the Supreme Court's recent decision in *Metropolitan Life Insurance Company v. Glenn*. The court analyzed whether the defendant's structural conflict of interest, as both the claims payor and administrator, affected its decision-making process when it adjudicated the plaintiff's benefit claim, including whether there was evidence of biased claims decisions. The court concluded that there was no evidence of bias in the record to support decreasing the applicable level of deference. Ultimately, the court concluded that the administrator's interpretation of the "Mental Illness" definition as including bipolar disorder was clearly reasonable.

Cases challenging whether mental illness definitions in ERISA-governed plans include bipolar disorder because of its purported biological cause have been litigated in a number of courts. This decision is in contrast to a number of those cases, decided under the de novo standard of review, which have held that bipolar disorder's status as a mental illness cannot be summarily decided. Jorden Burt acted as counsel for the defendant.

Court Dismisses Putative 412(i) Class Action

BY TODD FULLER

On February 19, 2009, Judge Boyle, U.S. District Judge for the Northern District of Texas, granted Indianapolis Life Insurance Company's individual motion to dismiss a putative nationwide class action filed against multiple insurers relating to the design, marketing and sale of life insurance policies purportedly used to fund IRS Code § 412(i) defined benefit pension plans. The court dismissed plaintiffs' conspiracy claim on the grounds that no facts were pleaded which suggested that the insurance company defendants "conspired with one another," and the court found "highly implausible" the allegation that several insurance company competitors all agreed to market and sell life insurance policies as part of defined benefit plans which they knew would be declared invalid several years later. The court dismissed plaintiffs' fraud claims for failure to plead fraud with specificity, and noted that the complaint failed to demonstrate why alleged representations regarding the validity of plaintiffs' § 412(i) plans made several years prior to IRS guidance issued in 2004 were false when made. The court also held that any predictions by an alleged Indianapolis Life agent regarding how the IRS would treat § 412(i) plans in the future was "either an unactionable opinion or was unjustifiably relied upon." Indeed, the Court found that Indianapolis Life was "not alleged to be specially situated to predict future tax treatment by the IRS, nor would it be reasonable for Plaintiffs to rely on such a projection." Jorden Burt represents Indianapolis Life in this case.

NAIC Winter National Meeting Highlights

BY STEVEN KASS

The NAIC held its Winter National Meeting in Grapevine, TX, December 4-8, 2008. The Meeting included discussion of the following topics:

- Annuity Suitability. The Suitability of Annuity Sales (A) Working Group took comments on a "Discussion Draft" (dated 11/14/08) of a revised Annuity Disclosure Model Regulation. After input and questions from Group members, industry and consumer representatives made presentations focusing on both broad and technical issues raised by the Draft (see the following article). The Group reached consensus that the Draft merited a full day workshop among regulators and interested parties.

- Annuity Illustrations and Disclosures. In May 2008, Iowa requested that insurers file annuity illustrations. Based on its review of hundreds of illustrations, Iowa summarized its findings to the Annuity Disclosure (A) Working Group and highlighted examples of good and problematic illustrations. The Group then discussed possibly amending the Annuity Disclosure Model Regulation to regulate illustrations. The Working Group held conference calls in February to consider this as well as disclosure of annuity guarantee fund protections.

- Reinsurance Regulatory Modernization Framework Proposal. The NAIC plenary formally approved the Proposal, which, among other things, provides for relaxed collateral requirements under specified conditions and the establishment of an NAIC Reinsurance Supervision Review Department. Following the Plenary's approval, New York and Florida announced they will withdraw and/or revise their own similar initiatives.

- Securities Lending Practices. At the Life Insurance & Annuities (A) Committee meeting, concern was raised about life insurers' securities lending practices, including accounting transparency and solvency risks, especially in stressed markets. It was also reported that these issues were being discussed in regulator-to-regulator meetings and by the Credit Default Swap (EX) Working Group.

NAIC Addresses Annuity Suitability

BY ANN BLACK

The November 14, 2008 discussion draft of the proposed revisions to the NAIC Suitability in Annuity Transactions Model Regulation laudably seeks to ensure that sales of annuities are suitable (see the previous article). It, however, does so in a proscriptive manner requiring substantial changes in annuity issuers' operations, as well as requiring increased training for producers as to suitability, categories of annuity products and the features of each distinct annuity product sold by the producer.

Under the draft revisions, annuity issuers must establish a *supervisory system* that requires *substantial involvement by annuity issuers* beyond a red flag system for identifying potentially problematic annuity sales for further review. Not only must insurers collect from the producer the requisite suitability information that must be considered prior to making a recommendation, insurers must mail within 14 days following each sale this collected information to consumers with a request to make any necessary corrections. To further ensure the information collected is accurate and producers are accurately and adequately explaining the annuity's material features, including the liquidity features of the annuity, insurers must call a sampling of consumers, as well as *all* consumers age 70 or older and consumers of flagged sales. There must also be assessments of compliance risks raised by high risk factors.

The draft revisions also require annuity issuers to establish a *supervisory organization* that is led by a senior executive, who is not responsible for sales or marketing. A supervisory officer must manage the day-to-day operations of the supervisory organization. The supervisory organization would include audit and special investigation units. Annually, the supervisory organization would report to senior management and the board audit committee as to the effectiveness of the supervision system, the exceptions found, and the recommended corrective actions. Moreover, every five years a third party qualified reviewer must review and prepare a report of the effectiveness of the suitability supervisory system.

Numerous commentators, including consumer representatives and regulators, raised questions regarding the proscriptive nature of the proposed revisions. It appears that the Suitability of Annuity Sales (A) Working Group will meet at the Spring NAIC meeting March 15, 2009.

Tax Clarifications Sought for Life Settlements

BY STEVE KRAUS

The recent development and growth of a secondary market for life insurance policies (known as Stranger-Owned Life Insurance, Investor-Owned Life Insurance, Trust-Owned Life Insurance or Charity-Owned Life Insurance) has presented a number of tax issues recently addressed by the Tax Section of the New York State Bar Association. In its report, the Tax Section asks the IRS:

- To clarify that Section 1234A of the Code (dealing with gains or losses from certain terminations) does not apply to death benefits under a policy;
- To clarify that the amount of gain realized on the sale of a policy would be ordinary income to the extent of a policy's cash surrender value and capital gains to the extent of any gain in excess of the cash surrender value;

Looking for a clearer picture on life settlements

- To confirm that a purchaser acquires a basis in the policy equal to the sum of the purchase price paid for the policy and the aggregate premiums paid on the policy (without reduction for amounts allocated to the "cost of insurance'"); and
- To clarify the application of Section 264(f) of the Code to the policy.

On the state level, the NAIC and NCOIL Model Acts have adopted different approaches to address the secondary life insurance market. The NAIC Model Act establishes a five-year moratorium on the settlement of policies not purchased with the policyholder's own money. The NCOIL Model Act, on the other hand, applies to all forms of life policies sold in the secondary market, classifying any practice involving such policies as a "fraudulent life settlement act." Since 2007, 14 states have enacted legislation dealing with the sale of life policies in the secondary market. State activity is expected to continue in 2009.

Life Insurance Capital & Surplus Relief Initiatives

BY STEVEN KASS

In November 2008, the ACLI asked the NAIC to consider nine proposals for providing life insurers capital and surplus relief on their December 31, 2008 statutory annual statements. The NAIC formed a Capital & Surplus Relief (EX) Working Group to consider the proposals and make recommendations to the NAIC Executive Committee and Plenary. The Working Group recommended adoption of six of the proposals (some with modifications), relating to reserve requirements, reinsurance collateral and accounting requirements. On January 29, 2009, the Executive Committee voted on a blanket basis to reject all the proposals. The general consensus of the Committee was that the industry had not demonstrated a sufficient emergency to warrant adopting the proposals retroactively for the 2008 annual statements. Committee members also indicated that some proposals may merit further consideration for subsequent reporting periods and suggested that these proposals be pursued through the NAIC's normal processes. Some Committee members also noted that if an insurer had specific issues relating to its 2008 annual statement, it should address those issues directly with its domiciliary regulator.

Subsequently, some of the proposals have been submitted in select states. Although all states have adopted the NAIC's accounting requirements, the respective states' laws generally grant their commissioners discretionary power to override the NAIC standards. This override authority can be exercised for all companies in the state, or on a company-specific "permitted practices" basis. As to pursuing proposals nationally through the NAIC in 2009, the most likely candidates would be variants of the proposals relating to mortality assumptions (i.e., determining reserves with preferred mortality tables for all 2001 CSO policies and eliminating deficiency reserves), facilitating commissioners' discretion on reinsurance collateral, and expanded recognition of deferred tax assets.

Scribner, Hall & Thompson, LLP

Has the IRS' "Investor Control" Analysis Changed?

BY SUSAN HOTINE

In a Chief Counsel Advice (CCA) released in October 2008, the Insurance Branch of the IRS National Office adopted an overly broad conclusion with respect to a variable contract and ownership of the underlying assets. The CCA states that "[w]here a segregated asset account directly invests in assets available to the general public, the policyholder and not the … [company] is the owner of the assets in the segregated asset account." This conclusion, as stated, is inconsistent with the paradigm for a segregated asset account, that is, a group of investment assets merely identified and segregated by the company. Also, the CCA's position seems to be a departure from an often-cited 1994 private letter ruling (PLR).

In both the PLR and the CCA:

- the company created a segregated asset account or non-RIC sub-account in which only a single policyholder would invest; in both, the assets in the account were publicly available;
- the policyholder participated in developing the parameters of the investment strategy to be used for the account; and
- the policyholder was prohibited from communicating with the investment manager or advisor for the account.

The PLR concluded that the company rather than policyholder was the owner of the assets held in the account. However, the CCA concluded that assets held directly by a segregated asset account that are available to the general public are owned by the policyholder for federal tax purposes.

Are there differences in the facts that might justify a different conclusion? Maybe. First, in the PLR, the investment manager was an employee of the company; in the CCA, there was a third-party investment advisor. Second, in the PLR, the policyholder helped develop broad investment strategies for the sub-account; in the CCA, the policyholder provided a detailed questionnaire re the nature of specific investments for the segregated asset account. Unfortunately, because the CCA lacks an analysis of how prior guidance applies with respect to the specific facts and only states the overly broad conclusion, we do not know what the CCA writers were really thinking.

Class Certification Denied by Arkansas Federal Court

BY JULIANNA MCCABE

In a class action involving the payment of benefits under supplemental cancer insurance policies, Judge Susan Webber Wright of the Eastern District of Arkansas denied plaintiffs' motion for class certification on numerous grounds. Judge Wright held that the named plaintiffs, who had already been paid substantial cash benefits under their policies, had a fundamental conflict of interest with absent class members because the relief that these plaintiffs requested would have driven up premium rates for absent class members. This "antagonistic" interest rendered the named plaintiffs inadequate class representatives. The court also held that the plaintiffs' claims were not "typical" within the meaning of Rule 23, and that the individual nature of policyholder claims, each of which involved different medical conditions, medical providers, dates of service, and a host of other individual facts, created manageability problems and destroyed predominance under Rule 23(b)(3). The court held that certification under Rule 23(b)(2) was also impermissible given the substantial claims for money damages involved in the case. Jorden Burt represented the defendant in this case.

Plaintiffs' request would drive up costs for absent class members

Xactimate Update: Court Dismisses All Claims

BY JOHN PITBLADO

As reported in previous issues of *Expect Focus*, Louisiana's Attorney General filed suit against several property insurers, alleging that they conspired and colluded among themselves, and with co-defendants Xactware, Inc., Insurance Services Office, Inc. and McKinsey & Company Inc., to artificially reduce the value of property claims by manipulating a claim database used as an industry reference (see *Expect Focus*, Vol. I, Winter 2008). The defendants removed the case to federal court and moved to dismiss the plaintiff's antitrust claims under the Louisiana Monopolies Act. The defendants argued that the complaint failed to allege either a conspiracy or any injury to competition, as required by the Act.

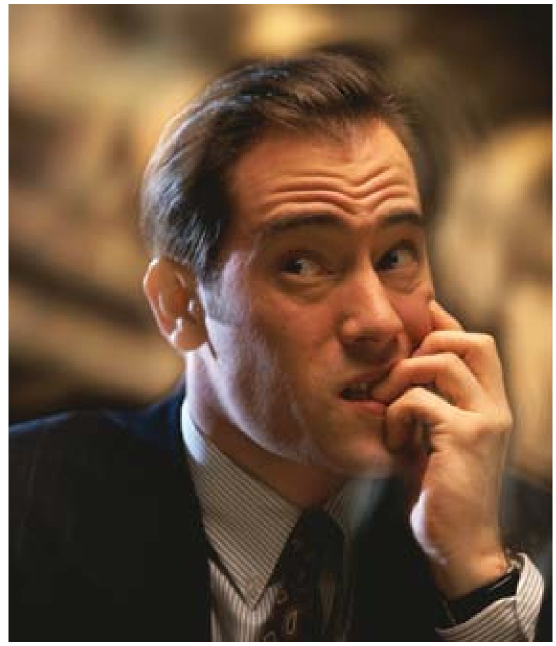
Case is thrown out

The court agreed with the defendants and dismissed all of the claims with prejudice at a hearing in open court on December 17, 2008. The court did not issue a written decision. The Louisiana Attorney General's office did not appeal or otherwise challenge the decision.

A Right Done the Wrong Way Is Actionable

BY JACOB HATHORN

Insurers in Washington state beware. Even in the absence of any duty on the part of an insurer to defend, settle, or indemnify its insured, the insured may still pursue common law bad faith and Washington Consumer Protection Act (WCPA) claims based solely on the insurer's procedural missteps in handling a claim. In the underlying action, RMS brought a class action lawsuit against Onvia. Onvia tendered the action to its liability insurer, St. Paul, but received no response until more than eight months later, when it received St. Paul's letter denying coverage and defense. Onvia assigned its rights against St. Paul to RMS.



Missteps in handling a claim might cause problems

In the underlying action, RMS brought a class action lawsuit against Onvia. Onvia tendered the action to its liability insurer, St. Paul, but received no response until more than eight months later, when it received St. Paul's letter denying coverage and defense. Onvia assigned its rights against St. Paul to RMS.

In the ensuing declaratory judgment action in *St. Paul Fire and Marine Ins. Co. v. Onvia, Inc.*, the district court held that St. Paul did not breach the insurance contract or act in bad faith when it denied coverage and defense to Onvia. Resolution of RMS's remaining claims against St. Paul, however, required an answer from the Washington Supreme Court on the following question:

> Under Washington law, does an insured have a cause of action against its liability insurer for common law procedural bad faith for violation of the Washington Administrative Code and/or for violation of the WCPA, even though a court has held that the insurer had no contractual duty to defend, settle, or indemnify the insured?

The court responded in the affirmative, reasoning that both an insurer's general duty of good faith and its specific duties under applicable claims-handling regulations should be read into every insurance contract. Accordingly, an insured may still pursue common law bad faith and WCPA claims based solely on the insurer's procedural missteps in handling a claim, even though the insurer's denial of coverage and defense was otherwise correct under the policy. While such claims are viable, however, an insured asserting them is not entitled to a presumption of harm or coverage by estoppel, and therefore must prove all of the elements of the claims, including actual damages.

Cancelation Notice by Certified Mail Inadequate Under Governing Statute

BY JOHN PITBLADO

The Supreme Court of Washington recently held, in response to a certified question from the Ninth Circuit Court of Appeals, that an insurer failed to comply with a policy cancelation statute by mailing the notice by certified mail instead of by regular mail. In *Cornhusker Cas. Ins. Co. v. Kachman*, the insurer, Cornhusker, sought a declaration that it properly canceled a commercial auto policy for non-payment of premium by the sending notice by certified mail.

Regular mail only for important notices

The notice indicated that the policy would be canceled if no payment was made by October 19, 2004. On October 22, 2004, an employee of the insured was involved in a fatal automobile accident, allegedly caused by the employee's negligence. The insured notified Cornhusker of the occurrence on October 25, 2004, and attempted to make its overdue premium payment, which Cornhusker received on October 28, 2004. The cancelation notice was returned to Cornhusker marked "undelivered" on November 1, 2004. Cornhusker returned the overdue premium payment to the insured and declined coverage for the claim based on the policy cancelation.

Cornhusker argued that the cancelation notice was effective under the statute requiring such notice to be "mailed" to the insured at its last known address. The Washington Supreme Court disagreed, holding that the notice was not "mailed" as the term is used in the statute, because certified mailing creates an additional duty on the part of the insured to either be at home or travel to the post office during business hours to receive the mailing. The Court stated that the statute did not impose such additional duties on policyholders.

Which State's Law Applies?

BY DAN CRISP

When analyzing choice of law issues, Florida courts traditionally apply the doctrine of lex loci contractus to the interpretation of contracts. In *United States Fidelity & Guaranty Company v. Liberty Surplus Insurance Corporation*, the U.S. Court of Appeals for the Eleventh Circuit certified to the Florida Supreme Court an "unsettled" question of whether the doctrine of lex loci contractus or the law of the situs of the risk applies to an insurance coverage dispute.

The underlying dispute involved a Florida apartment complex owner's construction defect claims against a Massachusetts-based contractor. The contractor purchased comprehensive general liability coverage from Liberty Surplus in Massachusetts. Liberty Surplus ultimately denied coverage when the complex's owner demanded arbitration with the contractor. After the contractor and the surety settled with the complex's owner, the contractor subrogated its contractual interests to the surety. The surety then filed an action against Liberty Surplus to recover the total settlement amount. The district court determined that the Florida Supreme Court would apply Massachusetts law under the doctrine of lex loci contractus, thus barring coverage under the policy. The surety appealed arguing that the law of the situs applied and the policy provided coverage under Florida law.

Based on the existing case law, the Eleventh Circuit determined that the choice of law question is unsettled. In one case, the Eleventh Circuit held that the Florida Supreme Court would depart from the doctrine of lex loci contractus and would apply the law of the situs of the risk when interpreting a contract that insured a stationary risk. In a recent automobile insurance dispute, however, the Florida Supreme Court broadly reiterated its adherence to the doctrine of lex loci contractus and also restated its rejection of the most significant relationship test. To resolve the choice of law issue, the Eleventh Circuit certified the question to the Florida Supreme Court.

Proposed Legislation Targets Related-Party Reinsurance Taxation

BY DAN CRISP

Related-party reinsurance transactions can provide certain tax advantages to offshore-based insurers and their U.S. affiliates. When U.S. risks are transferred to the offshore entity, the U.S. affiliate can generally deduct the premiums ceded from its federal income tax, and the offshore entity pays no U.S. tax on the ceded premiums. Additionally, if the offshore entity is headquartered in a low-tax or no-tax country, the entity could pay little or no tax on the investment income from the ceded premiums. U.S.-based insurers have argued that these tax laws place them at a competitive disadvantage.

Off-shore insurers might not be as tantalizing

On September 18, 2008, Richard Neal (D-MA), Chairman of the Subcommittee on Select Revenue Measures, introduced H.R. 6969. This legislation would amend the U.S. Tax Code to disallow deduction by a company subject to Section 831 of the Code of a certain excess amount of affiliated, non-taxed reinsurance premiums. Based upon aggregate data from company annual statements, the excess amount would be determined by line of business by reference to an industry average of premiums ceded to unrelated parties. H.R. 6969 was referred to the House Committee on Ways and Means.

On December 10, 2008, the Senate Finance Committee staff released a discussion draft of a bill that is nearly identical to the legislation introduced by Neal. The staff invited public comments until February 28, 2009, on issues such as the possible effect on insurance pricing and capacity, existing treaties and sovereignty rights, and the impact on the reinsurance market. A European insurance association has responded that such legislation would increase the price of insurance, violate double taxation treaties, and reduce reinsurance capacity. Neal plans to reintroduce this bill in the current session of Congress.

McCarran-Ferguson Does Not "Reverse Pre-empt" International Treaties

BY ROLLIE GOSS

In *Safety National Casualty Corp. v. Certain Underwriters at Lloyd's*, Lloyd's demanded arbitration to settle a dispute under a reinsurance contract, basing its demand on the Convention on the Recognition and Enforcement of Foreign Arbitral Awards. The district court denied a motion to compel arbitration, holding that under the McCarran-Ferguson Act, a Louisiana statute that prohibited arbitration agreements in insurance contracts reverse-preempted the Convention.

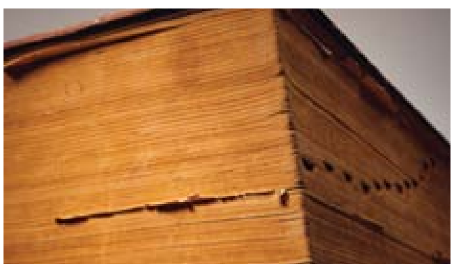
The Convention requires that courts of signatory states "shall, at the request of one of the parties, refer the parties to arbitration …." McCarran-Ferguson mandates that "No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance …." The U.S. Fifth Circuit Court of Appeals in Safety National addressed whether the Convention or its enabling legislation was an "Act of Congress" within the meaning of McCarran-Ferguson.

The Fifth Circuit held that treaties are not "Acts of Congress" within the meaning of McCarran-Ferguson, and hence are not reverse-preempted when they conflict with state laws. The court relied upon: (1) an analysis of the language of McCarran-Ferguson; (2) the absence of any indication that Congress, in enacting McCarran-Ferguson, intended to impair the executive power to negotiate treaties; and (3) that treaties are "something more than an act of Congress" due to their being negotiated by the Executive Branch and ratified by the Senate. The court rejected the contention that the Convention was an Act of Congress given that it was not self-executing and required an Act of Congress for its implementation, because that "does not answer the question of what Congress intended when it used the terms '[n]o Act of Congress' and 'such Act' in 1945 or why Congress would have addressed only treaties that required implementation by Congress."

Treaty Tips: Every Word Counts

BY ANTHONY CICCHETTI

The general rule of construction that contracts be read so as not to render any provision superfluous applies equally to reinsurance arrangements. For example, in *Imagine Insurance Co. v. State of Florida*, a Florida state appellate court applied this rule to allow a reinsurer to offset against a loss indemnity payment an amount equal to certain reinsurance premiums that were scheduled to be paid after the indemnity payment to the reinsured was made.



Check the dictionary

The reinsurance contract provided that "[a]ny loss payments from the Reinsurer shall be offset against any *outstanding* premium installments *due for the Contract Year*." The lower court sided with the reinsured's contention that the offset was inappropriate because no premium installments were "due" when the loss indemnity payment was made. The appellate court reversed, reasoning that the dictionary defined "outstanding" to mean "uncollected" and "unpaid." Moreover, according to the court, to construe the contract to permit offset only for past due and unpaid premiums would render superfluous the phrase "*due for the Contract Year*." The appellate court therefore concluded that the "more logical meaning of the Contract … contemplates the Reinsurer will offset, against any loss payments, the uncollected or unpaid premium installments remaining for the Contract Year."

Developments in State Regulation

BY DAN CRISP

State authorities, particularly in New York, have recently issued regulatory pronouncements on a number of reinsurance matters, including:

- New York's Office of General Counsel issued an opinion relating to assumption reinsurance, stating that the insured's consent must be obtained to effectuate a transfer of the contract and that state insurance law does not require foreign insurers' assumption reinsurance transactions to be filed with the insurance department, except in the case of life insurers. New York's Office of General Counsel also issued an opinion relating to credit for reinsurance with foreign entities, concluding that a New York domestic insurer may enter into a reinsurance agreement with an Illinois-based risk pooling trust and obtain credit for that reinsurance so long as the domestic insurer holds funds provided by the trust in accordance with certain New York insurance law requirements.

- The New York Insurance Department has proposed an amendment to Regulation No. 20 (121 NYCRR 125) - Credit for Reinsurance from Unauthorized Insurers. The amendment proposes application of principles-based credit risk management standards to all licensed ceded insurers, and provides an alternative credit for reinsurance ceded to unauthorized reinsurers, which adjusts the credit that the ceding insurer may take on its financial statement based on the financial strength of the unauthorized assuming reinsurer (as evidenced by ratings issued by Standard & Poor's, Moody's, Fitch, A.M. Best, or other rating agency recognized by the Securities Valuation Office of the NAIC).

- Connecticut issued a bulletin to accredited reinsurers regarding financial filing requirements for 2008 and 2009.

- Maine addressed the repeal by referendum of certain parts of "An Act To Continue Maine's Leadership in Covering the Uninsured." Part A of the Act established a reinsurance program for individual health insurance, but the state concluded that the reinsurance program could not be implemented because the funding provision and its revenue sources were repealed by the referendum and no other sources of funds were allocated or identified.

- Montana published an advisory memorandum explaining how certain provisions of the Terrorism Risk Insurance Program Reauthorization Extension Act of 2007 may require Montana insurers to file disclosure notices, policy language, and applicable rates.

- Hawaii proposed amendments to its Disclosure of Material Transactions regulation, including a definition of "material transaction" and the requirement that material, new ceded reinsurance agreements affecting in force life insurance business are to be subject to reporting requirements.

More on 151A

Uncertain Times for Indexed Annuities

BY KRISTIN SHEPARD

The SEC's newly-adopted Rule 151A will require most current forms of indexed annuities to be registered under the Securities Act of 1933, if those forms continue to be issued on or after January 12, 2011 (see also *Spotlight on 151A* on page 2). Though the SEC intends its new Rule to provide "increased regulatory certainty to insurance companies that issue indexed annuities and the distributors who sell them," the Rule raises many questions for issuers and distributors of these products.

The unanswered questions include:

1. What are the implications of Rule 151A for other insurance products with indexed-linked returns? For example, the SEC stated that, although Rule 151A does not apply to indexed life insurance policies, the "considerations that form the basis for Rule 151A are also relevant in analyzing indexed life insurance because indexed life insurance and indexed annuities share certain features (e.g., securities-linked returns)."
2. Will FINRA develop a new license series, examination and set of training materials tailored for indexed annuity salespersons?
3. What are the civil litigation implications of the SEC's position that indexed annuity policy forms issued on or after January 12, 2011 suddenly become securities even if the same form of indexed annuity was offered and sold on an unregistered basis prior to that date? On the one hand, the SEC maintains that nothing in its release adopting the rule is intended to affect the current analysis of the legal status of indexed annuities until the effective date of Rule 151A and that, in the meantime, offers and sales of unregistered indexed annuities will not be impacted by the pendency of the rule. However, the SEC also acknowledges that "if the status of a form of contract under the federal securities laws were to change, over time, from exempt to non-exempt and vice versa, this would present practical difficulties…as well as heightened litigation and enforcement risk."
4. Will the SEC and FINRA succeed in tailoring disclosure requirements for indexed annuities to avoid conflicts with or duplication of the myriad existing disclosure requirements mandated under state insurance and consumer protection laws?

Firm Accolades

Jorden Burt Recognized for Client Service

Jorden Burt LLP was recognized in the 2009 Survey of Client Service Performance for Law Firms: The BTI Client Service A-Team. Through surveys of corporate counsel at large and Fortune 1000 companies, Jorden Burt was named to the Honor Roll in eight categories of client service:

- Best at Commitment to Help
- Best at Understanding the Client's Business
- Best at Breadth of Services
- Best at Advising on Business Issues
- Best at Unprompted Communications
- Best at Bringing Together National Resources
- Best at Keeping Clients Informed
- Best at Anticipating the Client's Needs

James F. Jorden was named a BTI Client Service All-Star in a separate survey of Fortune 1000 companies in which corporate counsel was asked, unprompted, to name the top lawyers in the country who have provided the most "extraordinary attention to client needs", and "noteworthy successful responsiveness." For more information, visit www.jordenburt.com.

Intellectual Property & Technology

Outsourcing Service Provider Admits Finance Fraud

BY BRUCE LESHINE

Satyam Computer Services, an India-based outsourcing company that provides varied "back-office" IT and business process services to more than a one-third of the Fortune 500, announced that it had regularly provided false financial information in its public reports, fraudulently inflating its earnings and assets for years. More than 90% of Satyam's stated cash and short-term assets are nonexistent.

Companies contracted with Satyam are evaluating their back office operations and determining whether to terminate (or already terminated) their business dealings with Satyam. The *New York Times* quoted one analyst reporting that "we will see a lot of Satyam's clients migrating to competition like Infosys, TCS and Wipro."

Insurance and other financial services institutions that have entered into outsourcing arrangements will want to examine how best to protect their investments, whether the service provider is located in a foreign country or the U.S. For example, it can be helpful to:

- Diversify your "service provider portfolio" – As long as performance does not suffer as a result, distribute your outsourced IT and business process requirements across several service providers. Like investing, don't put all your eggs in one provider's basket.
- Be diligent in the selection and oversight of your service providers – Retain appropriate legal counsel and accounting advice in the evaluation of potential service providers.
- Perform ongoing reviews of your selected providers' performance and financials, including audits of their operating and financial books, records and on-site audits of their operations.
- Include flexible exit strategies in your outsourcing contracts (by amendment, if necessary). For instance, include the right to terminate the contract upon written notice and without penalty or liability in the event of possible "finance fraud" by the provider.

Patents for Financial Services Products are Restricted

BY DIANE DUHAIME & DAN CRISP

Under *Bilski*, business methods remain patentable but, as described below, the standard for granting such patents has now been limited. Bernard L. Bilski and Rand A. Warsaw's application to patent a method of hedging risk in the commodities market was rejected by the U.S. Patent and Trademark Office, and the Board of Patent Appeals and Interferences. The Applicants claimed a process that mentally and mathematically identified transactions that would hedge risk without the aid of a computer or any other device. Since the claimed method did not involve machines, the Federal Circuit analyzed the business method under only the transformation prong of the machine-or-transformation test. The court stated that the transformation must be central to the purpose of the claimed process and only specific types of articles may be transformed. Applying the transformation prong, the Federal Circuit affirmed the Board of Patent Appeals and Interferences because the Applicants' method did not transform any article to a different state or thing. The court explained that transformations of legal obligations or relationships, business risks, or other such abstractions are not eligible transformations under the test because they are not physical objects or substances and are not representative of physical objects or substances. A process claim may still be patent-eligible if it lacks physical steps, but the process must be tied to a machine or achieve an eligible transformation.

A petition for a writ of certiorari was filed with the U.S. Supreme Court January 28, 2009 in the case of *In re Bilski*. Although the Supreme Court may grant certiorari, patent owners and applicants will be reviewing the strength of their business method portfolios in light of the *Bilski* decision. For more information, visit www.jordenusa.com/news-1378.

Recent SEC Enforcement Action Under Fund Fraud Rule

BY TOM FINN & PAULA CEDILLO

The SEC recently brought one of its first enforcement actions under Rule 206(4)-8 of the Investment Advisers Act (the Fund Fraud Rule) in the case of *SEC v. Rabinovich & Associates, L.P.* The Fund Fraud Rule prohibits investment advisers to pooled investment vehicles such as hedge funds, mutual funds, private equity funds, and venture capital funds, from making false or misleading statements to investors or prospective investors, or failing to state material facts necessary to make statements to investors not misleading.

Making false statements will get you hung out to dry

Unlike other antifraud rules, the Fund Fraud Rule requires a showing of negligence, not scienter (the intent to deceive, manipulate, or defraud), and applies to both registered and unregistered advisers. Further, it is not restricted to transactions such as the sale of securities. As a result, many commentators viewed this as granting the SEC very broad enforcement authority.

In *Rabinovich*, the SEC alleged the defendants operated an unregistered investment company and broker-dealer. The defendants raised over $2 million from more than 150 investors by purportedly making fraudulent statements claiming that the firm had positive performance, that the firm was a member of the NYSE and NASD, as well as listing an address on Wall Street. The firm was actually operated out of a "boiler room" located in Brooklyn, had consistently lost money, and was not a member of the NYSE or NASD.

This case has given some confidence to the market that the SEC does not intend to use the Fund Fraud Rule to commence enforcement actions against advisers for subtle or nuanced disclosure omissions.

Disclosure Reforms and New Prospectus Delivery Options

BY SARAH JARVIS

After several years and much discussion and comment, the SEC has created a new disclosure framework for mutual fund prospectuses, meant to provide investors with information that is easier to use and understand. The new framework requires a summary section at the front of all statutory prospectuses and allows a new way to satisfy prospectus delivery obligations by delivery of a Summary Prospectus. Under changes to Form N-1A, all statutory prospectuses will now be required to disclose, in a summary section at the front of the prospectus, in plain English, the following information: (1) the investment objectives, (2) costs, (3) the principal investment strategies, risks, and performance, (4) the investment advisers and portfolio managers, (5) brief purchase and sale and tax information, and (6) financial intermediary compensation. Multiple fund prospectuses must present the summary information for each fund separately. Summary Prospectuses are to be composed of the same information in the same order.

No more headaches from SEC disclosure frameworks

Delivery of a Summary Prospectus will satisfy the prospectus requirements of Section 5(b)(2) of the Securities Act by complying with amended Rule 498 of the Securities Act. To comply, the Summary Prospectus must be sent or delivered "no later than the time of the carrying or delivery of the fund security," it must not be bound to any other materials, and the statutory prospectus and other information must be provided on the Internet and, if requested by the investor, in paper form. The effective date of the amendments to Form N-1A is March 31, 2009, with a compliance date of January 1, 2010 for all initial registrations, post-effective amendments that are annual updates to effective registration statements, and post-effective amendments that add a new series. The final compliance date for filing amendments to effective registration statements is January 1, 2011.

Adviser Lacked Standing to Sue on Behalf of Clients

BY STEPHANIE FICHERA

In *W.R. Huff Asset Management Co. v. Deloitte & Touche LLP*, the U.S. Court of Appeals for the Second Circuit held that an investment adviser lacked standing to sue for violations of federal securities laws on behalf of its clients. W.R. Huff Asset Management Co. (W.R. Huff), an adviser for institutional investors, brought suit against firms that provided underwriting, auditing, and legal services to Adelphia Communications Corporation (Adelphia), after Adelphia disclosed the existence of billions of dollars in debt that resulted in its dissolution in bankruptcy. W.R. Huff argued that its standing to sue on behalf of clients who had purchased securities sold by Adelphia was derived from its discretionary authority to make investment decisions for its clients and from a power-of–attorney in which its clients authorized W.R. Huff to bring the lawsuit.

Adviser out of luck on client's behalf

The Second Circuit rejected W.R. Huff's argument, finding that it failed to meet the "injury-in-fact" element of standing. The Second Circuit explained that "the minimum requirement for an injury-in-fact is that the plaintiff have legal title to, or a property interest in, the claim." The court held that neither the power-of-attorney nor W.R. Huff's authority to make decisions concerning litigation conferred legal title to or an ownership stake in the clients' claims against firms that provided services to Adelphia.

The court noted that W.R. Huff also failed to establish standing under prudential exceptions to the injury-in-fact requirement, which allow standing "where the plaintiff can demonstrate (1) a close relationship to the injured party and (2) a barrier to the injured party's ability to assert its own interests." The court found that the clients who purchased Adelphia securities were not hindered from asserting their own interests and the investment adviser-client relationship was not the type of "close relationship" that warranted a departure from the standing rules.

Hedge Fund Regulation—Round 2

BY ED ZAHAREWICZ

On January 29, 2009, Senators Chuck Grassley (R-IO) and Carl Levin (D-MI) introduced a bill in the Senate that would require most private investment funds with assets of at least $50 million to register with the SEC and to comply with certain other requirements. If enacted, the Grassley-Levin bill (S. 344), known as the "Hedge Fund Transparency Act," would impact not only hedge funds, but all private funds with assets of $50 million or more that currently rely on Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act, including private equity funds, venture capital funds, and certain insurance company separate accounts. The bill comes in the wake of the Madoff ponzi scheme scandal and failed rulemaking by the SEC to require hedge fund manager to register.

The bill would eliminate the exclusions from the definition of "investment company" under Sections 3(c)(1) and (7) upon which most private funds currently rely, and would amend Section 6(a) of the Investment Company Act to exempt from nearly all provisions of the Act any fund that meets substantially the same criteria as currently set forth in Section 3(c)(1) or Section 3(c)(7). A fund with assets of $50 million or more, however, would be so exempt only if the fund: (i) registers with the SEC; (ii) files annual disclosure form with the SEC providing certain basic information about the fund, (iii) maintains such books and records as the SEC may require, and (iv) cooperates with any SEC information or examination request. A fund that fails to comply with these requirements would become subject to the extensive provisions of the Investment Company Act, including the limits on leverage and fund governance requirements, as well as the Act's normal registration and filing requirements.

Although not directly addressed in the bill, it appears the bill would also effectively require managers of private funds with assets of $50 million or more to register with the SEC as investment advisers because the exemption from registration normally relied upon by such managers is not available to managers of registered investment companies. The bill would also direct the U.S. Treasury to finalize rules requiring hedge funds to establish anti-money laundering programs.

DOL Sues Adviser Over Alleged ERISA Violations for Improper Fund Investment

BY STEVE KRAUS

DOL hammering out alleged ERISA violations

As part of the Department of Labor's (DOL) Strategic Plan for Fiscal Years 2006-2011 to enhance pension and health benefit security, DOL established the Consultant Adviser Project (CAP), a national project that focuses on the receipt of improper, undisclosed compensation by pension consultants and other investment advisers. As a consequence of an investigation conducted under CAP, the DOL brought suit against Zenith Capital, LLC, a registered investment adviser and its executives.

The lawsuit alleges that Zenith and its executives violated ERISA's fiduciary responsibility provisions by causing the plans it managed to invest plan assets in a hedge fund while failing to disclose the fees it received from the hedge fund's sponsor and manager. In addition to paying Zenith undisclosed incentive fees, the manager of the hedge fund was a partial owner of Zenith.

The suit also alleges a number of other fiduciary failures including the adviser's alleged failure to perform due diligence on the fund, not acting in accordance with plan documents and investing plan assets in the fund even though the fund did not meet the stated objectives of the pension plans.

DOL is seeking the typical remedies provided in ERISA Section 409 in fiduciary breach cases: (1) requiring the defendants to restore all losses owned to the plans; (2) requiring defendants to undo any prohibited transactions; and (3) permanently barring the defendants from serving in a fiduciary or service provider capacity to any ERISA governed employee benefit plan.

No-Action Letter Expands Use of Past Recommendations in Ads

BY PATRICK LAVELLE

The SEC staff issued a significant no-action letter to TCW Group, Inc. on November 7, 2008, expanding the information that a registered investment adviser may include in advertisements. Specifically, the no-action letter permits the adviser to use contribution analyses in advertisements to demonstrate the five best and worst performing positions in an investment strategy portfolio.

Prior to this letter, registered advisers were generally prohibited from soliciting prospective clients with advertisements containing past profitable recommendations. Section 206(4) of the Investment Advisers Act, and Rule 206(4)-1, generally proscribe such advertisements unless all past specific recommendations for at least one year are listed. The purpose of the restriction is to prevent advisers from "cherry-picking" profitable recommendations for advertisements, and thereby creating a fraudulent or deceptively misleading picture of the client's account.

In the TCW Group, Inc. letter, the SEC staff indicated that, subject to certain conditions, it would not recommend enforcement action if the adviser used "Best Performers/Worst Performers" advertising charts. Taken as a whole, the conditions of the letter are designed to ensure that the adviser uses objective criteria for choosing portfolio positions in the charts and presents the positions in a balanced manner.

Past recommendations allowed in ad charts

Securities Class Action Torrent in 2008

BY PAULA CEDILLO

Securities class actions filed in 2008 were substantially more numerous than those filed in 2007 and almost double those filed in 2006. The subprime mortgage meltdown, the resulting financial markets crisis, the auction-rate securities debacle, and Ponzi scheme litigation have all contributed to this increase. Approximately half of all the securities class actions filed in 2008 were related to the financial markets crisis, many of which were filed in the final three months. We expect that the overall high level of securities class actions will continue well into 2009, particularly if the financial markets crisis continues to worsen. In this connection, December 2008 saw the first of the cases arising out of the several well-publicized Ponzi schemes that have now come to light, and we expect more of these cases (see also *Madoff Ponzi Scheme* on page 18). However, the number of auction-rate securities cases has fallen off, as most of the problems in that area seem now to have surfaced (and in many instances to be well on the way to resolution).

The most prominent category of defendants in the current wave of securities class actions has been firms in the financial products and services sector. Nevertheless, many other types of companies, as well as numerous natural persons, have also been swept in as defendants. For example, a number of companies outside the financial products/services sector that had exposure to Lehman Brothers, Fannie Mae, or Freddie Mac have been the target of securities class actions related to the financial difficulties those entities have experienced.

Along Comes Mary

BY TOM LAUERMAN

New SEC Chairman Mary Schapiro may preside over revolutionary changes in the scope of the SEC's responsibilities. Historically, Schapiro has shown no reluctance to expand her jurisdiction. As head of the NASD, Schapiro was a key backer of combining the NASD and NYSE regulatory functions to create the new FINRA.

Moreover, under Schapiro's leadership, FINRA supported the SEC's controversial Rule 151A (see *Spotlight on 151A* on page 2, and *Uncertain Times for Indexed Annuities* on page 12), which will have the effect of subjecting many sellers of indexed annuities to FINRA regulation for the first time. Similarly, FINRA has recently sought to expand the obligations of broker-dealers with respect to business activities that are conducted by their registered representatives outside the auspices of the broker-dealer firm. Finally, Schapiro and FINRA proposed to expand their functions to include serving as a self regulatory body for investment advisers.

Expanding the scope of the SEC

Congress may well decide to combine the SEC and the Commodities Futures Trading Commission (CFTC), as part of financial markets re-regulation in response to the current debacle. On paper, at least, no person would seem more qualified than Schapiro to head the combined entity; and, in that role, her experience in the NASD/NYSE combination would doubtless stand her in good stead. She would have the further advantage of her former experience as a CFTC chairman (in addition to her long experience as a securities regulator, including a previous stint as an SEC commissioner).

If she were to head a combined SEC/CFTC, Schapiro's regulatory turf would in some respects be wider than what she currently rules at the SEC alone. In other respects, however, the SEC's jurisdiction may be decreased. Various re-regulation plans currently under consideration contemplate that significant functions that the SEC currently performs might be best reallocated to a different agency.

Fair Value Accounting Report Disappoints Critics

BY PETER PANARITES

The SEC has disappointed those who want to significantly modify fair value accounting standards and to thus reduce the current stress on financial institution balance sheets. On December 30, 2008, the SEC delivered a Congressionally-mandated report of the staff of its Office of the Chief Accountant and Division of Corporation Finance concerning fair value accounting standards.

The report's conclusions include:

- There should be no suspension of the existing accounting standards that prescribe (i) when assets and liabilities should be valued on a "fair value" basis and (ii) when changes in the fair values should be "marked to market" (i.e., reflected in a company's income statement). The staff concluded that any such suspension would erode investor confidence in financial statements.
- Nor should SFAS 157 be suspended. SFAS 157 is the accounting statement that prescribes how to value assets and liabilities when the "fair value" method is being used. The staff concluded that suspension of SFAS 157 would lead to undesirable inconsistencies in determining fair values.
- Measures should be implemented to improve companies' application of the fair value standards in SFAS 157. Although the report identifies numerous general types of measures that should be implemented or considered, the report generally does not recommend specific measures.
- The accounting standards for financial instruments, including particularly for impairment of such instruments, should be simplified and otherwise improved. Again, specific recommendations are largely lacking.
- U.S. generally-accepted accounting principles (GAAP), including the standards applicable to fair value accounting, should continue to be designed to meet primarily the needs of investors for information about their investments. The staff believes that such informational needs of investors should take precedence over, for example, (a) any needs of regulators who may also seek to use a company's financial statements or (b) any concerns that a given accounting treatment might tend to increase the volatility of reported earnings.

Madoff Ponzi Scheme Leads to Suits Against Third-Parties

BY TOM FINN & LIAM BURKE

Although the dust from Bernard Madoff's collapsed scheme has barely begun to settle, a wave of lawsuits has already been filed. Notably, as the apparent scope and impact of the scheme has grown – particularly with respect to third-party funds and advisers that channeled assets to Madoff – so the plaintiff lawyers' pool of potential defendants has increased. In many cases, such third parties may be the most promising source of assets to pay plaintiffs' claims.

In December alone, investors appear to have initiated Madoff-related suits against at least seven distinct third party investment groups. This trend has continued in 2009, as more investors who thought they were investing with a fund or adviser they had confidence in, have discovered that their money was actually being invested with Madoff. Often, Madoff and the intermediary fund or adviser appear to have tried to keep Madoff's role secret from the investor.

Pyramids work better in architecture than finance

Oppenheimer Funds and Pioneer Investments are among the prominent U.S. organizations that have indicated that their customers have suffered Madoff-related losses. Nor have foreign organizations been spared. For example, two large European banks, Banco Santander and HSBC Holdings, report suffering Madoff-related losses of approximately \$3 billion and \$1 billion respectively. Reportedly, Spain's anticorruption prosecutor is investigating the relationships among Banco Santander, the investment fund Fairfield Greenwich Group, and the Madoff scheme, with a number of Santander clients contemplating suit.

In a somewhat similar situation, an investor has filed a suit naming Sonja Kohn, the chairwoman of Bank Medici AG in Vienna, Austria – and the woman behind much of Madoff's European business – alleging an improper failure to disclose that the investor's money was being funneled to Madoff.

White Collar & Criminal Defense

Laptops Unsecure at Customs

BY RICHARD SHARPSTEIN & JOHN BLACK

On April 21, 2008, the U.S. Court of Appeals for the Ninth Circuit handed down its decision in *United States v. Arnold*. The court held that the Fourth Amendment did not require U.S. Customs and Border patrol agents to have reasonable suspicion before undertaking a search of an individual's laptop or other electronic devices. This decision marks a significant development in the arena of personal privacy and civil liberties and may prove to have far-reaching effects on the business community.

Discuss laptop security before business travel

The Ninth Circuit, noting the government's interest in border control, determined that the search of digital and electronic devices did not infringe upon an individual's protected privacy rights, even if conducted without reasonable suspicion. The court found that such a search was not "particularly offensive" and refused to carve out a First Amendment exception.

Subsequently, on July 16, 2008, U.S. Customs and Border Protection issued a new policy written regarding border searches of digital information and devices. The new guidelines make it clear that customs agents may examine electronic information at border crossings and border-equivalents such as international airports. According to the guidelines, agents:

- Need not have individualized suspicion before conducting a search;
- May detain documents and electronic devices without a warrant;
- May conduct the search on-site or remove the devices and conduct the search off-site; and
- May share a copy of information gathered with other agencies and entities.

The guidelines make specific mention of business information and material protected by the Attorney-Client privilege. While the new guidelines acknowledge the sensitive nature of confidential information, it is clear that Customs officials may still be able to search these sensitive documents.

Non-Automated AML Procedures Inadequate

BY KAREN BENSON

Online broker-dealers using manual systems to monitor suspicious securities transactions for anti-money laundering (AML) compliance may need to rethink their approach.

On January 2, 2009, FINRA announced that it had fined two units of an online broker-dealer (E*Trade) $1 million to settle charges of failing to establish and implement AML policies and procedures that could reasonably be expected to detect and cause the reporting of suspicious securities transactions.

AML approach inadequate for online firm

According to FINRA, E*Trade's AML program lacked automated electronic systems specifically designed to detect potentially manipulative trading activity in customer accounts. Instead, E*Trade relied on analysts and other employees to manually monitor for and detect suspicious trading activity without, in FINRA's view, providing them with sufficient automated tools. FINRA determined that this approach to suspicious activity detection was "unreasonable," given the large volume of online trading activity, and concluded that E*Trade had violated applicable rules. E*Trade consented to the entry of FINRA's findings without admitting or denying the charges.

While FINRA has instructed all broker-dealers to consider generally the technological environment in which they operate, this administrative action suggests that the use of computerized surveillance tools to detect suspicious transactions and activity may no longer be optional for online broker-dealers that have high trading volume.

Rejection of Offer of Judgment Sinks Attempt To Plead Class Action

BY ELIZABETH BOHN

The District Court for the Southern District of Mississippi recently held that a plaintiff who rejected a Rule 68 offer of judgment for complete relief lost standing to amend the complaint to plead a class action. The plaintiff in *Frascogna v. Security Check* sued individually for an alleged violation of the Fair Debt Collections Practices Act based on the defendant's efforts to collect on a bad check. The defendant served an answer and a Rule 68 offer of judgment in the amount of the maximum FDCPA damages ($1,001 in statutory damages, $1,000 in actual damages, plus "reasonable costs and attorneys fees"). The plaintiff rejected the offer and moved for leave to file an amended class action complaint, which was granted by a magistrate judge. The plaintiff also filed a class certification motion. The defendant moved to dismiss and the court granted the motion for lack of jurisdiction, finding that the plaintiff lost standing and the court lost jurisdiction when plaintiff rejected defendant's offer of judgment which would have given him "all the relief he could hope to recover in this case." The court added that the loss of standing could not be revived by plaintiff's effort to certify a class because the class certification motion was filed after the Rule 68 offer had been rejected, and plaintiff failed to submit any evidence of additional damages to support a claim for more than what the defendant had offered.

Bad check leads to bad judgment for the plaintiff

TCPA Class Actions Barred Under New York Law

BY ARI GERSTIN

In *Bonime v. Avaya, Inc.*, the Second Circuit rejected a New York plaintiff's attempt to bring a putative class action in federal court based on alleged violations of the Telephone Consumer Protection Act because these claims would not be actionable in state court. The Telephone Consumer Protection Act (TCPA) makes it unlawful to send unsolicited advertisements to facsimile machines. The TCPA also creates a private right of action that allows a plaintiff to bring an action for recovery of damages for actual monetary loss or statutory penalties, if such an action would be "otherwise permitted by the laws or rules of court." The *Bonime* court found that the district court properly dismissed the plaintiff's claims because under New York law a class action for statutory damages is not actionable unless the statute imposing or creating the penalty specifically authorizes recovery in a class action. The Second Circuit explained that because the TCPA functionally operates as state law, the *Erie* doctrine must be applied to the TCPA. It added that following the state court precedent and dismissing plaintiff's case would further the twin aims of the *Erie* doctrine - discouragement of forum-shopping and avoidance of inequitable administration of the law. The court also found that dismissal of the plaintiff's claims was independently appropriate because the plain text of the TCPA provides that a private claim may not be brought under the TCPA if it is not permitted by state law, and New York state courts have found putative TCPA class actions to be barred under New York law.

TCPA - not in state court

Mark your Calendars

Gary Cohen, partner in the Washington Office, will moderate a panel on "Hot Topics in Insurance Products and Services" at the PLI Investment Management Institute, April 2-3, 2009. The panel will evaluate the SEC's indexed products proposed rule, address suitability and supervision concerns in product distribution, and keep up with synthetic products. For more information on the conference, visit www.pli.edu.

Fourth Circuit Stymies CAFA Removal

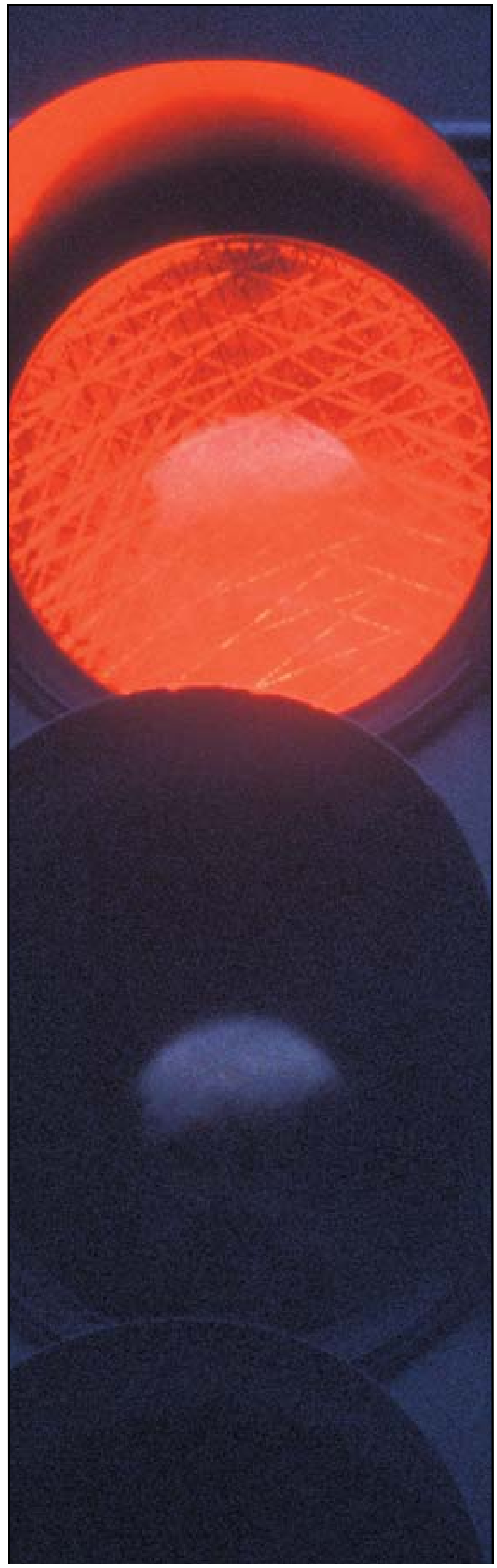
BY TODD FULLER

In a split decision, the Fourth Circuit recently held that a party joined as a counterclaim-defendant may not remove a case to federal court on the basis that the counterclaim satisfies the requirements of CAFA. In *Palisades Collections LLC v. Shorts*, a collection agency for AT&T brought a state court action for $794 in unpaid cell phone charges. The defendant answered and asserted a class counterclaim against the collection agency for alleged violations of the West Virginia Consumer Credit and Protection Act. The defendant later amended the counterclaim to join AT&T as an additional counterclaim-defendant, and AT&T removed the case to federal court under CAFA. The district court remanded the case, concluding that the removal was improper because AT&T was not a "defendant" for purposes of removal under § 1441, and CAFA did not create independent removal authority that would allow AT&T to circumvent the long-standing requirement that only a true defendant may remove a case to federal court. The Fourth Circuit affirmed, noting that under the Supreme Court's decision in *Shamrock Oil* and its progeny, the phrase "the defendant or the defendants" as used in § 1441(a) must be interpreted narrowly to refer to defendants as parties against whom the original plaintiff asserts claims. Because AT&T was not a defendant against whom the original plaintiff asserted claims, the court "easily conclude[d]" that AT&T was not a "defendant" capable of removing under § 1441(a). The court also held that even assuming CAFA provided removal power independent of that conferred in § 1441, there is no indication that it intended to alter the traditional rule that only original defendants may remove.

Ninth Circuit Nixes Consent Of All Defendants For CAFA Removal

BY MICHAEL SHUE

In *United Steel Workers v. Shell Oil Co.*, the Ninth Circuit recently held that, in cases with multiple defendants, CAFA entitles one defendant to remove an entire action. After United Steel Workers filed a class action in California state court against Shell Oil Company and Tesoro Refining and Marketing Company, each defendant filed its own notice of removal. Shell Oil's notice was filed first, but both notices asserted federal question and CAFA jurisdiction. The district court remanded the case to state court, however, and ruled that both notices were defective because neither included the consent of the other defendant. The Ninth Circuit reversed the remand, asserting that while the judge-created rule of unanimity has "traditionally required that all defendants consent to, or join in, removal," CAFA overrides this requirement. According to the court, "Because the case is governed by CAFA and the rule of unanimity is inapplicable, Shell removed the action as a whole, including claims against Tesoro." The court noted that Tesoro could not have prevented Shell's removal even if it wished to do so, let alone by filing a separate notice of removal. The Ninth Circuit joins the Eleventh Circuit in holding that CAFA removal does not require the consent of all defendants.



FTC Proposes SSN Regulation to Reduce Identity Theft

BY ELIZABETH BOHN

As previously reported, the FTC extended the deadline for compliance with the Fair and Accurate Credit Transactions Act (FACTA) Identity Theft "Red Flag" Rules from November 2008 to May 1, 2009. The Red Flag rules require financial institutions and creditors with consumer accounts and other accounts "for which there is a reasonably foreseeable risk of identity theft" to develop and implement written identity theft prevention programs incorporating policies and procedures targeted at reducing identity theft in connection with opening and maintaining such accounts.


Identity theft prevention … doesn't need a super hero

As part of its campaign to reduce identity theft, the FTC more recently issued a report recommending several measures to specifically prevent use of social security numbers for identify theft. A key recommendation of the report is that Congress consider adopting national standards strengthening required procedures for private-sector organizations to use in authenticating their customers' identities. Currently, only financial institutions regulated by the banking agencies are subject to nationwide authentication standards, and the report recommends that Congress consider establishing similar standards to cover all private-sector entities that maintain consumer accounts. Such standards would require organizations to adopt reasonable procedures for authenticating customers, but also would allow them to adopt a program compatible with their size and the nature of their business.

Class Certification Denied For Unjust Enrichment and Implied Warranty Claims

BY JAMES E. KIRTLEY, JR.

In *Ronat v. Martha Stewart Living Omnimedia*, the plaintiffs alleged that certain Martha Stewart brand patio tables sold at K-Mart had defective glass tops that tended to shatter spontaneously. The plaintiffs sought to certify a multi-state class for breach of implied warranty and unjust enrichment under the laws of several states. The district court denied class certification, noting the Seventh Circuit's recent decision in *Thorogood v. Sears, Roebuck & Co.*, which explained that federal court class treatment of "half a million claims wrested from the control of the courts of 29 jurisdictions in which those claims arose and the laws of which govern the claimants' entitlement to and scope of relief" would be inappropriate on Rule 23 superiority and manageability grounds, and would undermine federalism. Following *Thorogood*, the district court denied certification, stating: "[T]his Court can't grasp why a district court in Illinois should try implied warranty and unjust enrichment claims arising under the laws of [five states]." The *Ronat* court found that the plaintiffs failed to establish Rule 23 manageability or superiority, and that the proposed class and subclass definitions were "even more unmanageable because of differences in the statutes of limitations that apply under the different states' laws." The court also found that predominance was lacking because individualized proof of spontaneous shattering would be required by the class definition, and that inherent difficulties existed in identifying class members whose table tops had spontaneously shattered versus those whose tops either had not broken at all or had shattered due to some other cause.


Class and subclass were unmanageable

NEWS & NOTES

Speeches

Two Jorden Burt attorneys spoke at the American Bar Association Tort Trial & Insurance Practice Section's 35th Annual Midwinter Symposium, January 15-18, 2009 in Bonita Springs, FL. **Robin Sanders**, associate in the DC office and Vice Chair of the Life Insurance Law Committee of the ABA TIPS Committee, was on a panel "Lies, More Lies, and Oops!: Misrepresentations in Life, Health and Disability Applications." **Irma Solares**, partner in the Miami office, spoke on "Tier-Rating Of Health Insurance-When and Where Is Individual Re-Underwriting For Claim History Permitted?"

Joan Boros, Of Counsel in the DC office, discussed "Indexed and Synthetic Products: Case Studies in Securities Analysis" during the keynote speech at PLI's Understanding the Securities Products of Insurance Companies 2009 on January 5, 2009 in New York, NY.

Rollie Goss, partner in the DC office, spoke on "Adopting Web 2.0 Capabilities into your Web Presence" at LegalTech on February 3, 2009. He was invited to speak after the blog, Reinsurance Focus, was honored as one of the "Top Blogs" by Lexis Nexis.

Publications

Joan Boros authored "A Tumultuous Year for Annuities" in the December 15, 2008 issue of *National Underwriter: Life & Health.*

Rollie Goss authored a case note "Federal Arbitration Act Does Not Authorize Discovery Subpoenas to Non-parties to an Arbitration" for the Insurance Litigation Reporter Vol. 30 No. 21 in December 2008.

The Reinsurance Focus blog post "Court Confirms Reinsurance Arbitration Award Rejecting Numerous Procedural Challenges" written by **Rollie Goss** was republished in Mealey's Litigation Report Reinsurance, February 6, 2009.

Congratulations!

Julianna Thomas McCabe was selected as a Vice Chair of the Appellate Advocacy Committee Board, part of ABA's Tort Trial and Insurance Practice Section.

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JORDEN BURT LLP is the premier national legal boutique providing litigation services and counseling to the financial services sector. The firm serves clients in six key industries:

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For more information, visit our website at www.jordenburt.com.

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