EXPECTFOCUS®

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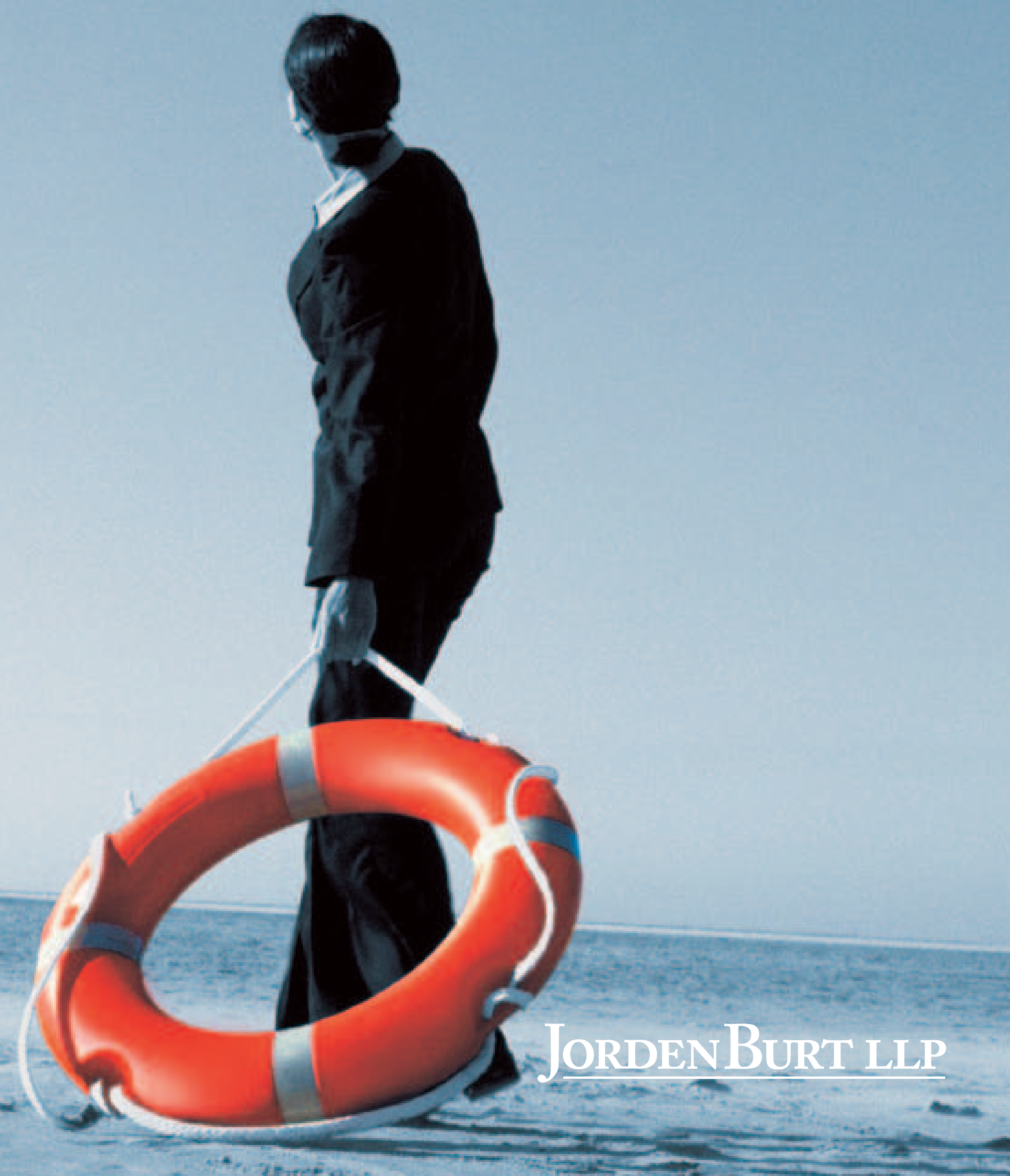
# Will Regulations Rescue the Financial Services Industry?



JORDENBURT LLP

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## INTHESPOTLIGHT

# Jorden Burt Trial Team Claims Victory in First Stanford Financial Group Criminal Trial

BYRICHARD SHARPSTEIN & ARI H. GERSTIN

In a stunning defeat for the Department of Justice, a federal district court judge in Miami entered judgments of acquittal in the first criminal trial related to the collapse of the Stanford Financial Group. After an eight-day trial, on the second day of jury deliberations, Judge Richard W. Goldberg declared Stanford's former Global Director of Security, Thomas Raffanello, and a former global security specialist not guilty. The pair was charged with one count of criminal conspiracy, and three counts of obstruction of justice related to an SEC investigation and receivership action in Texas.

Raffanello was the former DEA Chief in Miami who had led the investigation of Gen. Manuel Noriega. Upon retirement, he joined Stanford Financial. Prosecutors argued that a routine shredding of documents at Stanford's global security headquarters after a Texas court appointed a Receiver had interfered with an SEC investigation into the web of entities controlled by financier R. Allen Stanford. The executives did not contest that the shredding occurred however they maintained that all relevant documents were preserved electronically.

The defense showed that in the interest of safeguarding confidential personal and financial information collected for employee background and due diligence investigations, the company adopted a document retention policy and maintained a paperless environment. The defense further proved that the SEC and Receiver had access to all Stanford computer databases, including the server from the security office, and thus was in possession of all relevant materials. The court took judicial notice of the federal Electronic Signatures in Global and National Commerce Act (or E-SIGN Act) and other federal laws, which recognize that for security and privacy reasons, certain financial records may be kept or preserved electronically.

After hearing all of the evidence, Judge Goldberg questioned the government's lack of proof of any criminal intent on the part of the defendants, and in a rare move, took the case away from the jury and acquitted the defendants. Jurors who spoke to the media afterwards indicated that they were headed towards acquittals for both defendants, confirming the judge's ruling. If convicted on all counts, the men faced up to 50 years in prison.

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## Supreme Court to Rule on Key Class Action Issues

**BY JASON MORRIS**


The U.S. Supreme Court is set to issue rulings in two cases with potentially far-reaching class action implications.

In *Shady Grove v. Allstate Ins.*, the Court will decide whether the Second Circuit correctly held that a New York law banning class actions for specific forms of claims seeking statutory penalties from insurance companies barred plaintiffs from attempting to pursue such claims in federal court. On November 2, 2009, the Court heard oral argument on the issue, with Justices Sotomayor and Breyer expressing concern that such a law might interfere with the federal class action rule's policy concerns of promoting efficient and beneficial procedural mechanisms. Conversely, Justice Ginsburg indicated potential agreement with the Second Circuit by analogizing the New York law to state laws capping money damages.

In addition, on December 9, 2009, the Court heard oral argument in *Stolt-Nielsen v. Animalfeeds International Corp.*, in which the Second Circuit held that the Federal Arbitration Act permits arbitrators to impose class arbitration on parties whose arbitration clauses are silent as to that issue. Justices from both ends of the political spectrum expressed reluctance to accept the concept of contractual "silence," with Justice Scalia specifically stating that a contract must "either require [class arbitration] or ... not." However, he also expressed concern that arbitrators might conclude that a contract allows class arbitration on the basis of alarmingly weak language.

Jorden Burt LLP will continue to monitor and analyze the developments in these cases.

## State Prohibitions On Discretionary Clauses Not Preempted By ERISA

**BY ROBIN SANDERS**

On October 27, 2009, the U.S. Court of Appeals for the Ninth Circuit issued its highly anticipated decision in *Standard Insurance Company v. Morrison*, wherein the Court held that state laws, regulations, and insurance department conduct prohibiting the use of discretionary clauses in insurance policies issued as part of ERISA-governed employee welfare benefit plans are not preempted by ERISA. The court's decision is consistent with a prior decision by the U.S. Court of Appeals for the Sixth Circuit and significantly impacts the regulatory trend of states enacting laws and regulations prohibiting the use of discretionary clauses in insurance policies, including insurance policies issued as part of ERISA-governed employee welfare benefit plans. The practical implication of the court's decision, along with the Sixth Circuit's earlier decision, is that coverage disputes arising under insurance policies providing ERISA-governed benefits in those states within the Sixth and Ninth Circuits where discretionary clauses are prohibited will be adjudicated under a *de novo* standard of review, rather than the abuse of discretion standard of review that would have been applicable had a discretionary clause been included in the policy. Finally, it is noteworthy that the scope of the Ninth and Sixth Circuits' precedent does not extend to self-insured ERISA-governed plans, which still receive the benefit of the abuse of discretion standard of review if discretionary clauses are included as part of the plans' terms.

## *Scribner, Hall & Thompson, LLP*

# Extension of the NOL Carryback Period Also Applies to Life Companies

**BY LORI JONES & DAVE RIFKIN**

The Worker, Homeownership, and Business Assistance Act of 2009 allows taxpayers to elect to carry back an "applicable" net operating loss (NOL) or loss from operations up to 5 years, for a loss for a single taxable year ending after December 31, 2007, and beginning before January 1, 2010. For life insurance companies, this extends the 3-year carryback for losses from operations under I.R.C. § 810(b) to 4 or 5 years, to offset taxable income in those preceding years. An amount carried back 5 years is limited to 50% of the taxpayer's taxable income for that year, and the excess can be carried forward to later taxable years. Also, an "applicable NOL" includes a consolidated NOL.

Rev. Proc. 2009-52, 2009-49 I.R.B. 744, indicates that the same rules apply to NOL and operations loss elections. The election must be made by the due date (including extensions) for filing the return for the taxpayer's last taxable year beginning in 2009, either by attaching an election statement to the taxpayer's return (or amended return) for the taxable year of the applicable loss or by attaching an election statement to an appropriate form (i.e., Form 1139 or Form 1120X). A taxpayer that elected to forgo carrying back a loss for a taxable year ending before the Act's enactment – November 6, 2009 – may revoke such election before the due date.

Although the IRS guidance answers some questions, it leaves others unanswered. For example, is a life/nonlife consolidated group having both an "applicable" NOL and loss from operations limited to making the election for only one type of loss? If an election can be made for both, must the "applicable" NOL and loss from operations carryback be from the same year? Also, a point for companies to consider is, if the applicable loss would be carried to closed years, whether the carryback could be offset by otherwise-closed issues, thereby negating any carryback benefit.

# Supreme Court Denies Certiorari in 401(k) Fee Suit

**BY MICHAEL VALERIO**

On January 19, 2010, the U.S. Supreme Court denied plaintiffs' petition for a writ of certiorari in the *Hecker v. Deere & Co.* 401(k) fee case. (see *Expect Focus*, Vol. II, Spring 2009). The Court's denial marks the latest–and, most likely, ultimate–defeat for the plaintiff retirement plan participants in this putative class action originally filed in December 2006 in the Western District of Wisconsin.

*Failure to state claim plows down case against Deere*

In February 2009, a Seventh Circuit panel affirmed the district court's dismissal of plaintiffs' complaint alleging breach of fiduciary duty claims under ERISA. The plan participants' claims were brought against the plan sponsor (Deere), the plan recordkeeper (Fidelity Management Trust), and the investment adviser to the mutual funds offered in the Deere plan (Fidelity Management & Research). While the claims against Deere focused on its alleged imprudence in selecting allegedly higher-cost "retail" mutual funds rather than institutional funds, the claims against the Fidelity defendants were directed to their allegedly improper receipt and distribution of "revenue sharing" fees drawn from the asset-based charges imposed on fund shares.

In affirming the dismissal as to Fidelity, the panel held that revenue sharing fees are not plan assets for purposes of ERISA's fiduciary rules and need not be disclosed where the total fees charged by each mutual fund are disclosed. Moreover, despite the Department of Labor's amicus support for plaintiffs, the panel held that plaintiffs failed to state a fiduciary breach claim against Deere and, in any event, Deere was protected by ERISA's section 404(c) safe harbor because Deere provided plan participants with a sufficient mix of investment options with varying fees. After the Seventh Circuit denied plaintiffs' requests for panel rehearing and rehearing *en banc*, plaintiffs petitioned the Supreme Court for review of the panel's affirmance of the Deere dismissal, but not the Fidelity dismissals. Despite the ostensibly narrowed request, the Court denied the petition.

## Different Class Certification Outcomes in COI Cases

**BY BRIAN PERRYMAN**

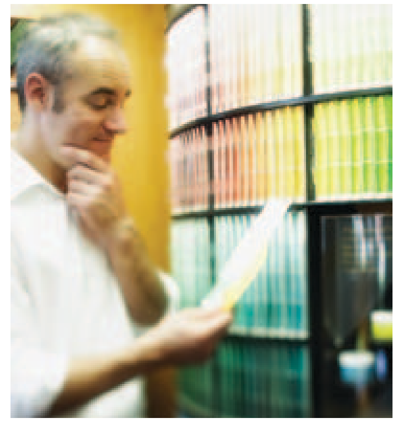
Two judges in the United States District Court for the Central District of California recently reached contrary conclusions as to whether a class could be certified in actions challenging cost of insurance charges.

In *Yue v. Conseco life Insurance Co.*, the named plaintiff alleged that when policyholders were procuring coverage, the defendant life insurer did not disclose its intent to impose COI increases beginning in policy year 21, and that the increases were unrelated to the defendant's expectations as to future mortality increases. The court certified nationwide and California-only class claims for declaratory and injunctive relief, finding that because the defendant had decided to increase the COI for all policies in uniform fashion, it was appropriate to evaluate the claims on behalf of the class as a whole to determine the increases' permissibility. Among other things, the court rejected the defendant's argument that differences in state contract law precluded certification.

The named plaintiff in *Gregurek v. United of Omaha Life Insurance Co.* represented a class of universal life insurance policyholders. The parties' central dispute concerned the interpretation of the COI charge, the plaintiff asserting that the charge should be calculated exclusively using factors related to a policyholder's mortality risks. According to the plaintiff, non-mortality costs such as profits and administrative costs were concealed in the COI. On the defendant's motion to decertify an earlier-certified class, the court held the class claims required a determination as to whether each policyholder actually knew that the COI charge covered non-mortality expenses, and whether it was reasonable for the defendant to believe that a policyholder knew the COI charge covered non-mortality expenses. Certification was improper because the parties' varying states of mind depended upon individualized sales presentations between policyholders and their sales agents.

## Class Certified in "Revenue Sharing" Case; 23(f) Sought

**BY BEN SEESSEL**



*Does the selection of options make one responsible?*

Connecticut U.S. District Judge Stefan Underhill certified a class of over 24,000 401(k) retirement plan trustees in an action alleging that Nationwide breached ERISA fiduciary duties by receiving and retaining "revenue sharing" payments from mutual funds offered as investment options under Nationwide annuity contracts issued to the trustees' plans. For plaintiffs to prevail in *Haddock v. Nationwide*, they must prove that Nationwide, which was neither an investment adviser nor a named fiduciary to the plans, nevertheless functioned as an ERISA fiduciary. Plaintiffs allege that Nationwide functioned as an ERISA fiduciary based on two theories, which were labeled by the court as the "specific accumulation unit" theory and the "mutual fund selection" theory. The court certified a "hybrid" class under Rule 23(b)(2), requiring notice and opt-out rights to class members.

In its petition for Rule 23(f) review, Nationwide attacks the merits of plaintiffs' theories of ERISA fiduciary liability and plaintiffs' ability to prove such theories on a class-wide basis. It argues that the "specific accumulation unit" theory is flawed because simple custody and control over plan assets is insufficient to render it a fiduciary. Nationwide further argues that the "mutual fund selection" theory is defective because merely selecting investment options prior to contracting with the plans did not make it a fiduciary, and neither did having the contractual right to substitute investment options, where the plans have "final authority" over what investment options are offered to plan participants.

In response, plaintiffs assert that Nationwide failed to demonstrate that class certification effectively terminates the case, and that none of Nationwide's arguments on the merits of their theories presented an important class action issue or made class certification questionable. Nationwide was granted leave to file a reply brief, in which it argues that class certification puts tremendous pressure on it to settle, that plaintiffs' theories of liability underlying class certification are "questionable," and that certification under Rule 23(b)(2) is improper because plaintiffs' request for monetary relief predominates.

## Florida Senior Suitability Rule Takes Effect

BY STEVEN KASS

The Florida Department of Financial Services adopted a rule, effective December 25, 2009, mandating that certain DFS forms be completed whenever an insurance producer or insurer recommends a purchase or exchange of an annuity to a senior consumer (a person 65 years of age or older). Two forms were promulgated through rulemaking: (i) an "Annuity Suitability Questionnaire," which is to be used for all recommended senior annuity sales and exchanges; and (ii) a "Disclosure and Comparison of Annuity Contracts," which is to be used for all senior replacement transactions (in addition to all other replacement requirements).

*New questionnaire in effect in Florida*

During the rulemaking process, insurers requested that the Rule provide an exception that would allow insurers to use their own forms, instead of the DFS forms, if their own forms were substantively similar. The DFS essentially rejected this request, although the final Rule does allow insurers, under limited circumstances and subject to DFS approval (as well as subsequent disapproval by Florida's Office of Insurance Regulation), to use alternative forms. Following the enactment of the rule (but prior to its December 25, 2009 effective date) a number of insurers requested a 30-day waiver to allow additional time to revise their systems before commencing use of the DFS forms, which limited requests were granted. In addition, one insurer requested a permanent variance from the requirement that specific disclosures be made in the Annuity Suitability Questionnaire form to senior consumers who refuse to provide requested information, with the request conditioned upon the insurer's agreement not to sell annuities to seniors who refuse to provide requested information. The DFS denied this request, but suggested that the insurer file an alternative Questionnaire for approval without the "refusal" disclosures, as such disclosures would be "not applicable" given the insurer's undertaking not to effect sales under such circumstances.

## Annuity and Life Insurance Guidance Included in Federal Agendas

BY STEVE KRAUS

The Treasury Department and IRS recently issued its 2009-2010 priority guidance plan, listing the projects it plans to finish by the end of June 2010. Of particular interest to our life insurance clients are the following projects:

1. Guidance on insurance contracts that mature after an insured reaches age 100. The IRS had issued Notice 2009-47, 2009-1 C.B. 1083, providing a proposed safe harbor for such contracts and seeking comments on this issue;

2. A revenue ruling on tax-free exchanges of life insurance contracts under IRC § 264(f) which was listed as a priority item on last year's list. IRC § 264(f), subject to a significant exception, disallows an interest deduction on a policyholder's indebtedness which bears a certain ratio to the average unborrowed cash values of the policyholder's life and annuity policies "issued" after June 8, 1997 to the sum of the average unborrowed cash values of such policies and the average adjusted bases of all other assets;

3. Guidance for annuity contracts that have a long-term care component. IRC § 7702B(e) provides that, subject to IRS regulations, the portion of any life insurance or annuity contract providing long-term care insurance coverage by a rider on or as part of such contract shall be treated as a separate contract; and

4. Guidance on the tax treatment of a partial exchange or annuitization of an annuity contract.

## Claim Brought Against Company is Not a Claim Made Against a Director or Officer

**BY JIM GOODFELLOW**

In *Medical Mutual Insurance Company of Maine* (MMIC) *v. Indian Harbor Insurance Company* (IHIC), the First Circuit Court of Appeals concluded that IHIC's denial of MMIC's claim made under a Directors and Officers (D&O) insurance policy was proper.

MMIC's former CEO filed a lawsuit against it, alleging disability discrimination. MMIC settled the lawsuit and sought reimbursement from IHIC. IHIC declined because the lawsuit was filed against MMIC alone and did not name any of its directors or officers. MMIC filed suit. The district court granted IHIC's motion for summary judgment, and MMIC appealed.

While MMIC contended that the CEO's complaint centered on allegations of wrongdoing by MMIC's directors and officers, the court disagreed and concluded that because MMIC was not listed as an insured person in the policy, it could not be afforded coverage. The court characterized MMIC's argument as an attempt to transform the D&O policy into a comprehensive corporate liability policy. The court emphasized that while D&O policies protect directors and officers from personal liability, they do not protect the corporation by which directors and officers are employed.

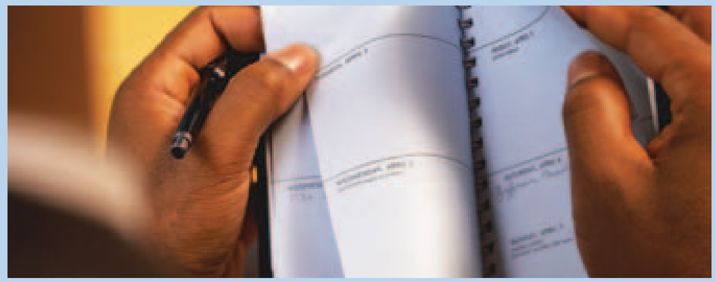
The court also rejected MMIC's argument that the settlement release signed by the CEO indicated a coverage obligation, insofar as the CEO agreed to waive any and all claims against MMIC "and its directors and officers." The court stated "it would make no sense to allow an insured to manufacture coverage by the simple expedient of insisting, as a condition of settlement, that a plaintiff frame a release more broadly than the plaintiff had framed the claim actually made."

*Directors and officers not included in claims made against company*

## Belt and Suspenders: Careful Structuring of Liability Transfer Pays Off

**BY JACOB HATHORN**

An insurer's shrewd deal structuring allowed it to take on only those liabilities of another insurer's failing business that it intended to acquire.



*Calendar worked in Hartford Fire's favor*

Hartford Fire Insurance Company entered a series of agreements with Reliance Insurance Company, whereby Hartford Fire acquired rights to, and became a reinsurer and servicer of, certain Reliance policies. One such policy was a D&O policy owned by G-I Holdings, Inc., which covered claims made from July 1999 through June 2002. When G-I learned of Reliance's impending insolvency in the summer of 2000, it sought protection by splitting its coverage between two new policies: (1) an amended Reliance policy with a new coverage termination date of June 30, 2000; and (2) a similar Hartford Fire policy covering claims made from that date through July 2002.

Three separate but related fraud actions brought against its directors and officers prompted G-I to tender claims under the policies, but Reliance was in liquidation and Hartford Fire denied coverage. Hartford Fire successfully defended against G-I's coverage claim arguing that the policy's "interrelated wrongful acts" provision governed, pursuant to which the filing date of all suits arising from the same wrongful act was the date on which the first such suit was filed. Because the first of the three fraud actions arising from the same alleged wrongful act commenced in January 2000, the court agreed that there was no coverage under the Hartford Fire policy. Moreover, the various agreements between Reliance and Hartford Fire further insulated Hartford Fire from direct liability. First, the asset purchase agreement transferred liability to Hartford Fire only for those claims made after June 30, 2000. Second, the claims servicing agreements expressly relieved Hartford Fire of any responsibility for payment of claims. Finally, the reinsurance agreement made Hartford Fire directly liable to Reliance and applied only to claims made after June 30, 2000.

## State Farm Appeals $310 Million Fine

**BY JOHN PITBLADO**

In 2003, State Farm Lloyds (State Farm), a previously non-rate-regulated insurer in Texas that provided homeowners insurance to millions of Texas residents, became subject to a then-newly enacted temporary rate regulation regimen by the Texas Department of Insurance (TDI) in 2003. State Farm filed its rates in June 2003, and TDI shortly thereafter found the rates excessive, and (1) ordered a 12% rate reduction and (2) ordered State Farm to refund policyholders who had been over-charged. State Farm appealed the order in the Texas district court, which found TDI's ruling unconstitutionally "confiscatory," as it essentially would have put State Farm at risk of insolvency (the refunds would have amounted to approximately $1 billion). TDI appealed, but the Texas appellate court affirmed.

Thereafter, in late 2008, TDI noticed a public re-hearing on the matter. The re-hearing took place between March and May of 2009. On November 16, 2009, TDI issued its order after re-hearing. Its order reduced the amount of the previously ordered reduction, resulting in a reduction of the refund TDI ordered to approximately $310 million. On December 7, 2009, State Farm timely appealed the order, which also included a provision noting that State Farm's refund obligations under the order are stayed until the matter is resolved in the courts.

## Be Careful Before Signing that Warranty Letter

**BY DAN CRISP**

In *Rivelli v. Twin City Fire Insurance Co.*, the plaintiffs, who were directors or officers at Fischer Imaging Co. (Fischer), sought to compel their excess D&O insurer, Twin City Fire Insurance Co. (Twin City), to advance costs to defend against an SEC civil enforcement action alleging securities fraud. The plaintiffs had already exhausted all other primary and excess D&O coverage in two previous shareholder lawsuits. In order to obtain the excess coverage at issue, Fischer supplied Twin City with a warranty letter, signed by the CEO, containing a "prior knowledge" exclusion, which stated that no person or entity to be covered "has any knowledge or information of any act, error, omission, fact or circumstance which may give rise to a claim which may fall within the scope of the proposed insurance." Notably, this letter did not include a severability provision, so that one insured's alleged knowledge or information would bar coverage for all insureds.

The SEC's allegations had described fraudulent actions that took place prior to the CEO signing the warranty letter. Consequently, Twin City refused to advance defense costs. The district court held that the "prior knowledge" exclusion in the letter barred coverage. On appeal, the Tenth Circuit rejected each of the plaintiffs' six assertions of error, holding, among other things, that the "prior knowledge" exclusion only required that the plaintiffs possessed knowledge or information that could give rise to a claim, not that the plaintiffs had realized that their alleged knowledge or information could give rise to a claim.

## Court Allows Action For Global Warming Damages

**BY JONATHAN STERLING**

In *Comer v. Murphy Oil USA, et al*, the Fifth Circuit Court of Appeals refused to dismiss a lawsuit brought by private citizens against alleged polluters for property damage allegedly caused or worsened by global warming. In Comer, Mississippi Gulf residents sued a variety of energy and chemical companies for damages caused by Hurricane Katrina. The plaintiffs claimed that the greenhouse gases produced by the defendants caused a rise in sea levels that made Hurricane Katrina more severe. They asserted a variety of common law tort claims based on damage to their own private property, as well as to certain public property useful to them. The claims included nuisance, trespass and negligence.

The defendants moved to dismiss plaintiffs' claims, arguing that the hurricane damage was not fairly traceable to defendants' actions and therefore the plaintiffs lacked standing to bring their claims. The court rejected this argument with respect to the nuisance, trespass and negligence claims and found that, taking the plaintiffs' allegations, which included references to scientific reports, as true, a sufficient link was alleged. Defendants also argued that the political question doctrine prohibited the court from ruling on the claims. However, the court held that the claims did not present a question exclusively committed to the discretion of the legislative or executive branches, noting that the case involves state law tort actions for damages. The Fifth Circuit therefore reversed the district court's granting of the motion to dismiss. The October 2009 *Comer* ruling followed a similar September 2009 decision by the Second Circuit in *Connecticut v. American Electric Power Co.*

## Asset Rating Requirement for Reinsurance Trusts Clarified in NY

BY STEVEN KASS


Reinsurance trusts are a common means of securing a reinsurer's obligation to a ceding company. For arrangements subject to New York law, such trusts are established under New York's Regulation 114, which limits the types of assets that may be held in the trust to specific categories, including those of the type specified in select paragraphs of Section 1404(a) of the New York Insurance Code. One type of eligible investments consists of "A" rated (or higher) obligations of American institutions. Regulation 114 does not, however, specify when the rating requirement is measured, leaving open the question of whether a security that was "A" rated when placed in the trust loses its eligibility under Regulation 114 if subsequently down rated.

The Office of the General Counsel of the New York Insurance Department addressed this question in an opinion dated September 30, 2009, OGC Op. No. 09-09-06. In that opinion, the OGC noted that Section 1401(b) of the New York Insurance Code provides that "All financial tests and other requirements for the making of any investment are satisfied if complied with on the date of acquisition by the insurer, except as otherwise permitted by this chapter or by regulation." The OGC then interpreted this language to mean that "absent any express legal or regulatory authorization to the contrary, any financial requirement (such as the rating of a given security) is measured as of the date of acquisition of the security." Applying this standard, the OGC concluded that, because nothing in Regulation 114 or elsewhere in New York Insurance Law specifies otherwise, any assets contributed to a Regulation 114 trust must meet any applicable statutory rating requirement as of the asset's acquisition date.

## Arbitration Treaty Prevails Over State Insurance Law Prohibiting Arbitration

BY ROLLIE GOSS

In September 2008, a panel of the U.S. Court of Appeals for the Fifth Circuit held that a Louisiana law that prohibits the arbitration of insurance disputes did not reverse-preempt the Convention on the Recognition and Enforcement of Foreign Arbitral Awards through the McCarran-Ferguson Act, preserving the treaty's provisions relating to arbitration as they relate to insurance matters. Fourteen months later, the entire Fifth Circuit, sitting en banc in *Safety National Casualty Corporation v. Certain Underwriters At Lloyd's, London*, reached the same conclusion. Both opinions held that an international treaty is not "an Act of Congress" within the meaning of McCarran-Ferguson, and hence is not preempted by contrary state law, maintaining the superiority of treaties over state law. The most recent opinion notes that the decision conflicts with a 1995 decision of the Second Circuit Court of Appeals, which reached a different result in an analogous situation.

## Treaty Tips: Don't Leave It to a Court to Interpret The Parties' "Deems"

**BY ANTHONY CICCHETTI**

The interpretation of the words "or so deemed" will dictate whether a reinsurer will be liable for reinsured losses under an excess loss workers' compensation and employers' liability reinsurance treaty. So concluded the U.S. Court of Appeals for the Third Circuit in *Princeton Insurance Company v. Converium Reinsurance (North America) Inc.*

Converium's obligation under the treaty to reimburse Princeton for reinsured losses was made "subject to" certain warranties. In the warranty at issue, the ceding company stated that "the maximum Employers' Liability limits are as follows, *or so deemed*: Bodily Injury by Accident - $500,000 each accident." Princeton issued a policy containing the "bodily injury by accident" limit in a state where the limit was unenforceable, and an Employers' Liability claim settlement of $4.4 million resulted. Converium sought a declaratory judgment to the effect that the warranty provision limited the reinsurer's liability for Employers' Liability claims to $500,000. The usual contract interpretation tussle ensued.

*"Or so deemed" interpretations could be a nightmare*

Princeton prevailed at the District Court level on the theory that Princeton had complied technically with the warranty, and if the parties had intended to limit the reinsurer's Employers' Liability exposure to $500,000, they would have done so explicitly and directly, not indirectly through the warranty. The Third Circuit disagreed, concluding that the lower court's analysis incorrectly ignored the "or so deemed" clause. Although the Third Circuit appeared to look more favorably on the reinsurer's argument, it found that the treaty wording was ambiguous and should have prevented the lower court from disposing of the matter on summary judgment. The judgment of the District Court was vacated, and the case was remanded for further proceedings.

## Scottish Court Breathes New Life Into Petition To Approve Solvent Scheme Of Arrangement

**BY BRIAN PERRYMAN**

The Scottish Court of Session, Inner House, has reversed a ruling of its Outer House refusing to approve a scheme of arrangement under the U.K. Companies Act of 2006.

A scheme of arrangement is a reorganization device through which a company may compromise its creditors' claims with the approval of at least three-quarters of its creditors. A scheme of arrangement generally involves three stages. First, there must be a judicial application for an order summoning a meeting of creditors. Second, the scheme proposals are put to the meeting and are approved (or not) by the requisite majority. Finally, if the scheme is approved at the meeting, there must be a further application to the court for sanction of the arrangement.

In *Petition of Scottish Lion Insurance Company*, Scottish Lion, in runoff since late 1994, proposed in 2008 a scheme of arrangement to terminate exposures under short- and long-tail policies. The scheme was opposed by U.S.-based creditors insured under general liability or general aviation insurance policies with Scottish Lion. The Outer House declined to approve the scheme, concluding that sanctioning the scheme smacked of "unreasonableness" to minority creditors, and asking rhetorically, "where the Company is sound financially, why should one group of creditors who might wish to enter into a commutation agreement with the Company be entitled to force other creditors to participate against their will?" The Inner House disagreed. Although the court acknowledged that insureds who were being required to accept current estimated values in lieu of their contingent claims may "possibly with other arguments, win the day," it concluded that such circumstance alone was not so overwhelming a factor against the sanction. The case was remitted to the Outer House for further proceedings.

NOTE**WORTHY**

*Privacy and Corporate Data Security*

## Congress to Pass Data Security Breach Legislation?

BY PAULA CEDILLO & DAN CRISP

Congress appears one step closer towards passing federal legislation aimed at the protection of personal information. On December 8, 2009, the House of Representatives passed the *Data Accountability and Trust Act* (H.R. 2221) (DATA). DATA would require those entities doing business in interstate commerce that maintain data containing personal information (including those that contract with another party to maintain such data) to comply with future Federal Trade Commission (FTC) regulations designed to protect such data from disclosure, identity theft, and fraud. DATA would also specify requirements for data breach notification. DATA violations would be regarded as unfair or deceptive acts or practices in violation of Section 5 of the FTC Act, and state attorneys general would be able to bring a civil action when residents of their respective states are adversely affected by a violation. The bill was received by the Senate and referred to the Committee on Commerce, Science, and Transportation on December 9, 2009.

Prior to the House's passage of DATA, the Senate Judiciary Committee approved two similar bills. The first bill, the *Data Breach Notification Act* (S. 139), would establish notification standards for any agency or entity engaged in interstate commerce that suffers a data breach compromising personal information. The second bill, the *Personal Data Privacy and Security Act of 2009* (S. 1490), would require entities to implement an appropriate data privacy and security program, set data breach notification requirements, and enhance criminal punishment for various privacy-related violations. These two bills are slated to proceed to the full Senate for vote.

With health care and financial reform as top priorities, the Senate may not take any action on these bills in the near future. Such legislation would hopefully provide businesses with a comprehensive set of guidelines for effective information security practices and data breach notification, and would likely preempt much of the current patchwork of state data privacy laws

## Financial Services Firm Settles Privacy Class Action Lawsuit

BY PAULA CEDILLO & DAN CRISP

In early 2008, D.A. Davidson & Co. (Davidson), a Montana-based investment firm, discovered that a computer hacker illegally obtained access to a database containing personal and financial information of its current and former clients. Shortly thereafter, Davidson notified the affected parties and offered them one year of credit monitoring at its expense. Davidson subsequently extended the free credit monitoring offer from one year to two years.

Despite these initial efforts at remediation, in May of 2009, those affected by the data breach filed a class action lawsuit against Davidson alleging claims of negligence, breach of contract, breach of fiduciary duty, and violations of the Fair Credit Reporting Act and the Montana Consumer Protection Act. On November 12, 2009, the U.S. District Court for the District of Montana approved the settlement of the action, finding that the settlement was fair, reasonable, adequate, and in the best interests of the settlement class. The terms of the settlement included: (1) $185,000 in legal fees to the plaintiffs' attorneys; (2) a $1,000 incentive award to each representative plaintiff; (3) reimbursement to each settlement class member for any actual and unreimbursed out-of-pocket damages up to $10,000, with aggregate damages liability to all settlement class members limited to $1,000,000; and (4) a deadline of and including June 1, 2011, for the filing of claims.

As of the date of the approved settlement, there were no reported identity thefts resulting from the database breach. The ultimate amounts to be paid by Davidson pursuant to the terms of the settlement are not known. Regardless, this class action lawsuit and settlement demonstrate the critical importance of protecting customer data, monitoring for data breaches, and timely complying with data privacy laws in the event of data breaches.

*WASHINGTON MONITOR—An inside look at key regulatory agencies*

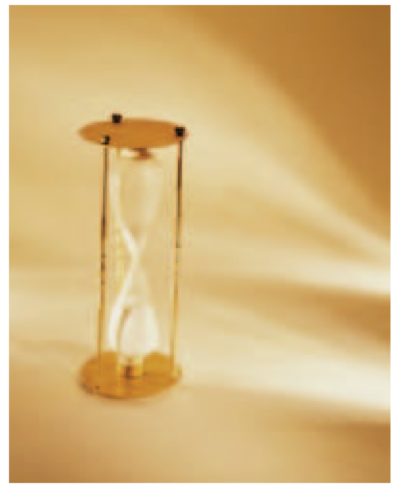
# SEC Fights To Save Rule 151A

**BY GARY COHEN**

The SEC is taking steps to save Rule 151A. It has consented to a two-year stay of the Rule's effectiveness, and will analyze the impact of Rule 151A on efficiency, competition and capital formation.

The SEC announced these steps in a brief filed in December with the U.S. Court of Appeals for the District of Columbia Circuit. OM Financial Life Insurance Company (Old Mutual) had asked the court to stay the Rule until two years after the SEC has reissued or revised the Rule. The court ordered Old Mutual and the SEC to file briefs on the motion.

The court has not yet ruled on Old Mutual's motion. It could stay or vacate the Rule, or decide on some other remedy, such as setting a deadline for the SEC to reach a determination. Meanwhile, the court has ordered Old Mutual to file a brief addressing the SEC's proposal to defer the Rule's effective date.



*Is time on the SEC's side?*

**Two-Year Stay**

Old Mutual's motion to stay the January 12, 2011 effective date set by the SEC for Rule 151A has opened the door for the court to vacate the Rule. As a result, the SEC appears to have determined to swallow the less bitter pill of staying the Rule for two years after the original or a revised Rule is published in the Federal Register.

In the meantime, however, issuers and distributors of indexed annuities are caught in a time bind. Because of pending litigation and legislation, it is uncertain whether the Rule will ever take effect, let alone on January 12, 2011. Companies are faced with spending time and money to comply with SEC and FINRA requirements by the looming deadline when it's highly uncertain whether compliance will be required.

**Analysis of Impact**

The court has found Rule 151A to be reasonable under Supreme Court precedents. However, the court remanded the Rule back to the SEC to conduct an analysis of whether the Rule will promote efficiency, competition and capital formation. The court found that the SEC had failed to undertake the analysis as required by Section 2(b) of the Securities Act.

The SEC has told the court that it will conduct a Section 2(b) analysis. In its brief, the SEC states that the staff has "taken significant steps" to "diligently" address the deficiencies the court found in the SEC's Section 2(b) analysis of the proposed Rule. The SEC says that its staff has "conducted a comprehensive survey of state insurance regulation of indexed annuities."

The SEC intends for its staff to complete the Section 2(b) analysis and make a recommendation to the Commissioners by Spring 2010. The SEC states that "if the staff recommends retaining Rule 151A, the staff also expects to recommend that the SEC seek public notice and comment on the efficiency, competition, and capital formation analysis."

# 401(k) Participant Permitted to Sue for Breach of ERISA Fiduciary Duties

**BY STEPHANIE FICHERA**

In *Braden v. Wal-Mart Stores, Inc.*, the Eighth Circuit Court of Appeals recently reversed a district court's judgment dismissing a putative class action brought by a 401(k) plan participant who alleged that Wal-Mart, the plan's sponsor and administrator, and various executives involved in the management of the plan breached fiduciary duties imposed by ERISA. The plan had over one million participants and nearly $10 billion in assets and included ten mutual funds in its menu of investment options. The plaintiff challenged the defendants' process of and motivations in selecting the mutual funds for inclusion in the plan, claiming that the funds charged unjustifiably high fees and that revenue sharing payments constituted improper kickbacks to the plan's trustee. While noting that ERISA plaintiffs usually lack the "inside information" necessary to make detailed claims prior to the commencement of discovery, the court held that the district court erred by failing to draw reasonable inferences in favor of the plaintiff and that the plaintiff had sufficiently asserted a claim for breach of fiduciary duties.


*Braden* departs from a Seventh Circuit decision issued in early 2009, *Hecker v. Deere & Co.*, that dismissed similar challenges to mutual fund fees and revenue sharing practices in connection with a 401(k) plan. Differing factual circumstances underlying the selection of the respective plans' mutual funds and the variety of funds offered were factors in the opposite outcomes. Distinguishing *Hecker*, the *Braden* Court pointed out that the 401(k) plan at issue in *Hecker* featured over 2,500 investment options with varying expense ratios whereas the *Braden* plan offered only ten and determined that the plaintiff's claim that the plan was imprudently managed was more plausible than the allegations in *Hecker* in light of the plan's limited investment options, selected despite the availability of other options.

# Labor Department Withdraws Investment Advice Regulation

**BY STEVE KRAUS**

On November 19, 2009, the Department of Labor (DOL) officially withdrew its regulation that would have allowed advisors, who are affiliated with insurance companies and mutual funds that sell investments to plans, to provide investment advice to plan participants and beneficiaries. The regulation implemented a statutory prohibited transaction exemption that was enacted as part of the Pension Protection Act (PPA). It also contained a prohibited transaction class exemption providing additional relief for investment advice provided to individuals following the furnishing of recommendations generated by a computer model as provided for in the PPA and the implementing regulation. The effective date for the embattled rulemaking was originally to be March 23, 2009, but was subsequently delayed several times in response to public comments critical of the rulemaking, most recently until May 17, 2010.


*Doubts raised warnings to DOL*

In its release announcing the withdrawal of the regulation, DOL stated that "[it] decided to withdraw the rule based on public comments that raised sufficient doubts as to whether the conditions of the final rule and the class exemption associated with the rule could adequately protect the interests of plan participants and beneficiaries." DOL was responding to comments that the regulation and class exemption did not adequately deal with potential investment adviser self-dealing and that if conflicts were not mitigated, advice might be tainted. Other comments expressed concern with the DOL's interpretation of the statutory "fee-leveling" requirement which allowed the receipt of varying fees, rather than level fees, by an affiliate of a fiduciary adviser.

## SEC Adopts Amendments to Custody Rule for Registered Investment Advisers

**BY SCOTT SHINE**

The SEC has adopted amendments to Rule 206(4)-2 under the Investment Advisers Act of 1940. The amendments modify what's known as the Custody Rule and are designed to increase safeguards over client funds in the custody of SEC-registered investment advisers.

Under the new amendments, advisers who maintain custody of client assets through an affiliated qualified custodian will now be subject to an annual surprise examination unless they can demonstrate sufficient operational independence from the custodian. In a departure from the proposed rule, the surprise examination will not apply to advisers who have custody based only on their ability to deduct advisory fees directly from a client's account. As a result, it is expected that far fewer advisers will be subject to enhanced oversight.

Pooled investment vehicles are now subject to surprise examinations as well unless their annual audited financial statements are provided by an independent accountant registered with, and subject to regular inspection by the PCAOB. The proposed rule would have subjected pooled investment vehicles to the surprise examination without exception.

The SEC has also heightened the requirements for advisers to form a "reasonable belief" that the qualified custodian has sent account statements directly to clients by requiring advisers to conduct a "due inquiry." The SEC did not provide a single method for satisfying this standard but rather left advisers with flexibility to determine how best to meet the requirement.

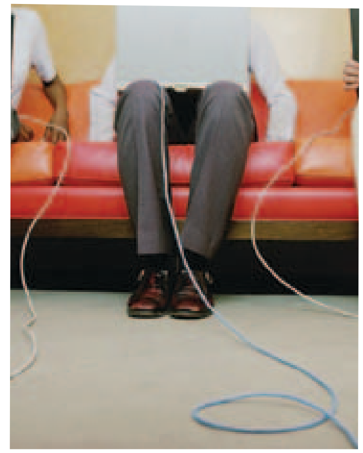
In an effort to enhance their ability to identify compliance risks associated with custody of client assets, the SEC also adopted several amendments to Part 1A and Schedule D of Form ADV requiring advisers to report more details about their custody practice.

Although the final rule is scaled back in certain respects from the proposed rule, the SEC has signaled its intentions to make custodial practices a key area of focus in response to various high profile frauds in the past year.

## SEC Adopts Model Privacy Form

**BY ED ZAHAREWICZ**

In a joint release with other federal regulators, the SEC has published final rule amendments to Regulation S-P, which implements the privacy provisions of the Gramm-Leach-Bliley Act (GLBA) with respect to brokers-dealers, investment companies, and investment advisers that are registered with the SEC. Regulation S-P requires that these registrants provide initial and annual privacy notice to their customers, informing them of the registrant's information-sharing practices and of the customer's right to opt out of certain sharing practices. The rulemaking, which went into effect on December 31, 2009, includes a model privacy form that registrants may rely on as a safe harbor to provide disclosures required to be made under Regulation S-P. For privacy notices provided after December 31, 2010, the rulemaking also will eliminate the guidance associated with the use of notices based on the Sample Clauses set forth in Appendix B of Regulation S-P.



*Information-sharing practices to be shared with customers*

Use of the model form is voluntary. Thus, while the model form provides a legal safe harbor, registrants may continue to use notices that vary from the model form, so long as the notices comply with the requirements of Regulation S-P. Similarly, while the SEC is eliminating its guidance on the use of Sample Clauses for notices provided after December 31, 2010, registrants may continue to use notices containing these clauses provided the notices comply with the requirements of Regulation S-P.

The rulemaking fulfills a mandate of the Financial Services Regulatory Relief Act of 2006, which amended GLBA to require the federal agencies responsible for the implementation of GLBA to propose a succinct and comprehensible model form that allows consumers to easily compare the privacy practices of different financial institutions, and has an easy-to-read font. Still under consideration by the SEC are proposed amendments to Regulation S-P that would, among other things, set forth more specific requirements for safeguarding information and responding to information security breaches, and broaden the scope of the information covered by Regulation S-P's safeguarding and disposal provisions.

## Court Upholds Mandatory Arbitration Clause

**BY SARAH JARVIS**

The use of mandatory arbitration clauses in advisory agreements may become more widespread after the U.S. District Court of Minnesota's decision to enforce such a provision in *Bakas v. Ameriprise Financial Services, Inc*. Previously, the SEC had called the enforceability of such clauses into question in a 1986 interpretive letter which advised that arbitration clauses in advisory agreements may violate the antifraud provisions of the Investment Advisers Act by misleading clients. In the letter, the SEC stated that the advisory contract "should disclose that the clause does not constitute a waiver of any right provided by the Act, including the right to choose the forum, whether arbitration or adjudication."

The plaintiff in *Bakas* sought to rely on the SEC's interpretive letter, among other arguments, to avoid an arbitration clause included in her advisory services agreement and bring a class action against Ameriprise for breach of contract and improper practices under the Advisers Act. The Court instead held Bakas's claim subject to arbitration under the clause, adding that "because the legal landscape has changed in the 23 years since the [interpretive] Letter, Bakas's reliance on it is misplaced." The 1953 Supreme Court case that the interpretive letter relied on had been expressly overruled in 1989 and was, the Court noted, "no longer good law." The *Bakas* Court also noted that the "hostility to arbitration of such [federal securities] claims" shown by the 1953 Supreme Court "no longer applie[s]." To read how current legislation initiatives affect such clauses, see "Financial Regulatory Reform Threatens Manadatory Arbitration Provisions," page 17.

## SEC Extends AML Relief

**BY PATRICK LAVELLE**

In a January 11, 2010 no-action letter to the Securities Industry and Financial Markets Association, the SEC Division of Trading and Markets agreed to extend a 2004 no-action position for an additional 12 months. The position allows a broker-dealer to rely on the performance of an investment adviser to satisfy certain of its obligations to maintain a Customer Identification Program (CIP) under 31 C.F.R. 103.122 (the CIP Rule). This is the fourth time the SEC staff has extended the expiration date for the no-action relief.

*Broker-dealers have 1 year before the extra paperwork*

As part of its anti-money laundering (AML) compliance program, a broker-dealer must establish, document, and maintain a written CIP appropriate for its size and business that satisfies the minimum requirements of the CIP Rule. Under the CIP Rule, a broker is able to rely on another financial institution to perform certain of the broker-dealer's CIP obligations if, among other things, the other financial institution is subject to a rule implementing an AML program. The no-action relief enables broker-dealers to continue to rely on investment advisers, which are currently not subject to an AML program rule, to perform the broker-dealers' CIP obligations.

The no-action letter confirms the previously issued position, "subject to some modifications." In particular, the Division stated that it will not recommend enforcement action if a broker-dealer treats an investment adviser as if it were subject to an AML program rule provided:

- All other CIP rule provisions are satisfied;
- Reliance on the adviser is reasonable;
- The adviser is registered with the SEC;
- The adviser enters into a contract with the broker-dealer requiring it to certify annually to the broker-dealer that it has implemented its own AML program that is consistent with the statutory minimum requirements for such programs; and
- The advisers (or its agent) performs the specified requirements of the broker-dealer's CIP.

The no-action position is scheduled to be withdrawn without further action on January 10, 2011.

## SEC Turns Up Heat on Insider Trading

**BY LIAM BURKE**

Subpoenas that the SEC recently has been sending to hedge funds and broker-dealers have sought much more information about possible insider trading violations and requested much broader access to firm personnel than was typical of such inquiries in the past. Toward the end of 2009 alone, more than three dozen such subpoenas reportedly were issued. By way of example, one such subpoena:

- sought the names of all individuals with authority over trading decisions at the recipient hedge fund and
- requested that every email sent or received by each such individual – over the course of more than two years – be produced.

*Wiretaps and informants in insider trader sting*

Additionally, the SEC is no longer satisfied by being provided with documents and phone records; now the SEC also is requesting interviews with employees that have been identified in response to its insider trading subpoenas.

The SEC's aggressive new approach is also evidenced by its use of wiretaps and confidential government informants (in cooperation with the U.S. Attorney's Office and the FBI) in connection with the highly publicized insider trading ring allegedly associated with the Galleon hedge fund operation and its founder. Interestingly, in the Galleon case, investigators were tipped off by a single text message that had been buried in documents voluntarily turned over to the SEC by Galleon in 2007. Under pressure from the government, the author of the text message later agreed to record her telephone calls with Galleon's founder, which paved the way for a subsequent wiretap. With the wiretap in place, investigators were able to significantly expand the reach of the investigation.

## Regulatory Reform Threatens Mandatory Arbitration

**BY TOM LAUERMAN**

Major reform initiatives currently proceeding through Congress have provided a fresh opening for opponents of the mandatory arbitration provisions that broker-dealers commonly include in agreements with their customers.

A bill passed by the House (H.R. 4173) would specifically empower the SEC to prohibit, condition, or limit the use of mandatory arbitration provisions by broker-dealers, investment advisers, or municipal securities dealers. Similarly, a major draft reform bill that the Senate is considering would mandate that the SEC take such action, if the SEC "finds that such prohibition, imposition of conditions, or limitations are in the public interest and for the protection of investors."

Although both of these bills appear to give the SEC the ultimate discretion as to whether to impose any prohibitions, conditions or limitations on mandatory arbitration provisions, the SEC has not indicated what its views on that question may be. Moreover, both bills also would require the Comptroller General to evaluate and report to Congress on FINRA's arbitration program.

The SEC could also be influenced by the new Consumer Financial Protection Agency (CFPA) that both H.R. 4173 and the Senate draft would create. The CFPA would have the power to prohibit or limit mandatory arbitration agreements with respect to financial products or services that are within the CFPA's jurisdiction. Even as to products and services that are not within the CFPA's jurisdiction, both bills would mandate coordination and consultation between the CFPA and the SEC, with the object of promoting comparable treatment of products and services that are similar to or compete with one another.

Thus, as a practical matter, the SEC, the Comptroller General, the Congress, and the CFPA could all have considerable influence on the fate of mandatory arbitration provisions, if this legislation becomes law.

To read about one court's decision to uphold such a clause, see "Court Upholds Mandatory Arbitration Clause," page 16.

## FINRA Tackles Compensation Issues

**BY MARILYN SPONZO**

FINRA has proposed a new Rule 2040, which would generally replace existing NASD rules regarding payments by broker-dealers to unregistered persons. Instead, firms would be required to look to SEC rules, regulations and published guidance to determine whether such payments are permissible.

However, with respect to payment of continuing commissions to retired registered representatives, the proposed rule would codify existing NASD interpretive material. Specifically, the proposed rule would allow such payments, but only pursuant to specific provisions of a written contract executed between the representative and his broker-dealer prior to retirement. The rule would define a retiring registered representative as an individual who retires from a member firm and leaves the securities industry, and would clarify that, if the representative dies, payments may be directed to the representative's beneficiary designated in the contract or the representative's estate if no beneficiary is so designated.

Notice 09-69 also proposes amendments to FINRA Rule 8311 governing payments to persons subject to suspension, revocation, cancellation, bar or other disqualification. The proposed amendments would clarify that:

- The rule applies to all disqualifications, and is not limited to orders issued by FINRA or the SEC;
- Where Rule 8311 prohibits any payments, the prohibition applies to all remuneration to the sanctioned representative, and is not limited to payments resulting from securities transactions;
- The prohibition applies to all trail commissions accruing during the period of the sanction;
- The prohibition does not apply to compensation accruing prior to the effective date of the sanction, unless such compensation relates to or results from the activity giving rise to the sanction; and
- The prohibition does not preclude remuneration pursuant to an insurance or medical plan or indemnity agreement regarding legal fees.

## Proposed SEC Funding Changes Not Mere Bean Counting

**BY TOM LAUERMAN**

Financial reform legislation passed by the House of Representatives (H.R. 4173) would allow the SEC to collect fees from investment advisers designed to defray the SEC's cost of inspecting and examining them.

Unless FINRA or some other self-regulatory organization was given responsibility for investment advisers, it seems inevitable that the SEC will, in the future, be devoting substantially more resources in this area. Under H.R. 4173, however, the amount and structure of the fees that the SEC could impose for this purpose would be largely within the SEC's discretion. Under this "self funding" arrangement, the SEC's ability to expand its investment adviser examination/inspection program (and the attendant costs to advisers), would be subject to few practical limitations.

Accordingly, H.R. 4173 would greatly increase the possibility of "overregulation," as compared with the historical procedure under which the SEC generally has been able to expend only such amounts as have been specifically appropriated to it by Congress.

The risk of such overreaching by the SEC may be even greater under the draft financial regulatory reform bill currently under consideration in the Senate. That is because the Senate draft would permit the SEC to "self fund" (i.e., through fees it prescribes, rather than through Congressional appropriations) a broader range of its activities.

Even in areas where the SEC is not permitted to self-fund its activities, Congressional appropriations are likely to increase substantially. Wholly apart from the investment adviser examination/inspection program, for example, H.R. 4173 would double the SEC's budget over the next few years.

Under any likely scenario, firms within the SEC's jurisdiction should probably assume that substantial increases in the SEC's resources will result in more rigorous regulation going forward. On the other hand, financial reform bills such as discussed above would assign many significant new tasks and responsibilities to the SEC, which would absorb at least some of the agency's increased resources.

## Congress, Federal Regulators Seek to Promote Use of Annuities in 401(k) Plans

**BY SCOTT SHINE**

Recent market declines have spurred demand for products within 401(k) plans that can mitigate investment and longevity risks by offering a guaranteed income feature.

In this regard, the Department of Labor and the Treasury Department have publisshed a joint request for public input on how to facilitate the use of annuities in employer-sponsored retirement plans. The annuities in question might be fixed or variable and could provide a variety of traditional or more modern guaranteed income or withdrawal benefits.

Historically, annuities have suffered from certain disadvantages in the 401(k) context, including:

- Administrative complexities, such as complying with joint and survivor annuity requirements;
- Potential fiduciary liability for sponsors who select an annuity for use in their plan;
- Lack of "portability" of certain guaranteed income or withdrawal benefits, if the employee wants to "roll-over" into another plan; and
- The challenge of adequately informing employees concerning the complexities of many annuity products.

One idea is to provide plan sponsors with additional "safe harbor" relief for plan sponsors who select annuities. (This would perhaps expand upon certain limited safe harbor relief that the Department of Labor issued in 1995 for the selection of annuity providers by fiduciaries.)

On the legislative front, The Lifetime Income Disclosure Act has been introduced in the Senate, which would require 401(k) and other defined contribution plans under ERISA to disclose annually to plan participants how much income they could expect in retirement if they rolled their plan assets into an annuity product. This information would hopefully encourage plan participants to save more and move their savings into annuities offering guaranteed income streams. Additionally, proposed legislation in the House and Senate would, if adopted, incentivize employees to annuitize a portion of their retirement assets by offering a 50 percent tax exclusion annually on up to a specified amount of lifetime annuity payments.

## FINRA Enforcement Pattern Favors Automated AML Procedures

**BY KAREN BENSON**

FINRA recently fined Scottrade $600,000 to settle charges of failing to establish and implement an adequate anti-money laundering (AML) program to detect and trigger reporting of suspicious transactions, as required by the Bank Secrecy Act and FINRA rules. This action, together with an earlier FINRA action against two units of E-Trade, shows that FINRA will be skeptical toward AML programs of high-trading volume online brokers that do not use computerized surveillance tools to detect suspicious transactions and activity.

As a general matter, FINRA has advised firms that, in designing their AML programs, they should consider certain factors, including the technological environment in which they operate. FINRA also has specifically instructed online brokers to consider conducting computerized surveillance of account activity to detect suspicious transactions.

According to FINRA, Scottrade's AML program lacked automated systems to monitor customer accounts for suspicious transactions. Instead, according to FINRA, Scottrade relied almost exclusively on internal personnel to identify and refer potentially suspicious activity to the firm's risk management department, which relied solely on the AML compliance officer to investigate referrals to determine whether activity was suspicious and reportable. FINRA found, however, that neither the AML compliance officer nor anyone else at Scottrade specifically monitored transactions for potentially suspicious trading activity. FINRA also found that Scottrade's AML procedures failed to provide adequate written guidance to its employees as to how to monitor and detect suspicious activity.

FINRA determined that the firm's reliance on inadequate internal resources, along with the large volume of online trading activity, rendered the lack of automated systems to detect suspicious activity unreasonable. FINRA also determined that, when Scottrade subsequently implemented an automated system, the system had remained inadequate because it focused only on suspicious trading that was accompanied by suspicious money movement.

## Revised Class Definition Does Not Sustain CAFA Removal

**BY MICHAEL WOLGIN**

*Adding new class members at the last minute?*

In *In re Safeco Insurance Company of America* (October 2009), the Seventh Circuit affirmed the lower court's remand of a class action filed prior to but certified after the enactment of the CAFA. The case was filed in Illinois state court prior to CAFA for alleged underpayments of insurance claims. After the Illinois court certified a class with a new class definition that for the first time included the claims of insureds who were issued policies by non-party affiliates of the defendants, the defendants claimed that the certification commenced a "new action" and removed the case to federal court under CAFA. The defendants argued that the inclusion in the new class definition of claims made by insureds of the affiliates added new causes of action that did not relate back to the original complaint. The defendants further argued that certification had created a new action because it had expanded the scope of their potential liability. The district court remanded the case, and the Seventh Circuit affirmed, holding that CAFA did not apply because the new claims did, in fact, relate back to the original pre-CAFA complaint. The Seventh Circuit explained that "the essential inquiry is whether the original pleading furnishes the defendant with notice of the events that underlie the new contention." The court held that here, the original complaint contained adequate information to place the defendants on notice that they faced potential liability for their use of a specific claims-processing system, regardless of which affiliate issued the policy under which the claims at issue were made. Because the defendants knew or should have known from the original complaint of the potential for expanded exposure, the "workaday changes" to the class definition did "not create new litigation for CAFA purposes."

## Arizona Terminates Interlocutory Review of Class Certification Denials

**BY KIM FREEDMAN**

In *Garza v. Swift Transportation Co., Inc.*, the Arizona Supreme Court held that the court of appeals lacked jurisdiction to entertain an appeal from an order denying a motion for class certification. The plaintiff, a truck driver, had filed a class action complaint on behalf of drivers who had contracted with the defendant trucking company, alleging that the company systematically underpaid its drivers. The trial court denied class certification. The court of appeals assumed appellate jurisdiction and vacated the lower court's ruling. The Arizona Supreme Court vacated the decision of the court of appeals on two primary grounds. First, the court relied on the U.S. Supreme Court's decision in *Coopers & Lybrand v. Livesay*, which concluded that class certification orders were not independently appealable as a matter of right. Second, the court concluded that the Arizona statute providing for appellate jurisdiction essentially limited review to appeals from final judgments and the denial of class certification did not fall within any of the statutory exceptions. The court's holding expressly overruled *Reader v. Magma-Superior Copper Co.*, a 1972 decision in which the Arizona Supreme Court had determined that a narrow exception to statutorily mandated finality applied to denials of class certification.

*Truckers have to hit the road in AZ*

## Leaky Tubs Sink Plaintiffs' Class Certification

**BY CLIFTON GRUHN**

In *Evans v. Lasco Bathware*, a California appellate court affirmed denial of class certification based on the need for individualized damage determinations, which the court found trumped the commonality factor. According to the plaintiffs, a defective design in a shower pan replacement system caused unique damages to the area surrounding the tub. The plaintiffs' expert testified that the damages were capable of calculation through a formula that would obviate the need for individual damage assessments. The defendants argued that no such formula was available because of the various materials and techniques used for installing its shower pans.

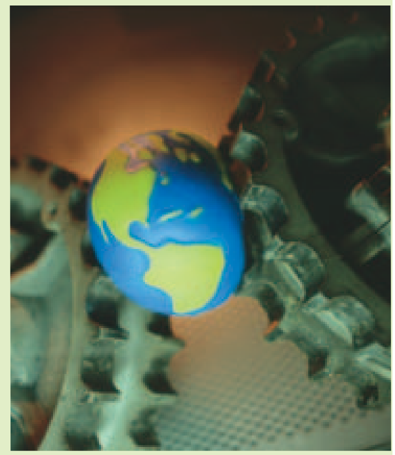
Noting that the evidence both supported and refuted the plaintiffs' contention that a formula could be used to determine class-wide damages, the appellate court found that sufficient evidence existed on which the lower court could base its finding that individualized damages were not amenable to a one-size-fits-all formula. In addition to individualized damages barring class certification, the court noted that the proposed class representatives were inadequate because in an apparent attempt to avoid individualized damage determinations from blocking certification, they attempted to limit the claims of putative class members to replacement of the shower pans. The court found that this limitation "forfeit[ed] additional recoveries… class members might otherwise be entitled to recover," and concluded that the representatives did not adequately represent the class members' interests.

*Leaky tub class hung out to dry*

## Standards of Review for Class Certification Appeals Narrowed

**BY JONATHAN HART**

In *Yokoyama v. Midland National Life Insurance Company*, Aug. 28, 2009, the Ninth Circuit narrowed the deferential standard of review that is generally afforded to district court class certification decisions. The plaintiffs' complaint alleged that the defendant marketed annuities in violation of the Hawaii Deceptive Practices Act. The district court denied class certification based on its conclusion that the Act required a showing of individualized reliance. Because the denial of certification was premised on a purely legal issue, the appellate court employed a de novo review and reversed the district court's decision, finding that reliance under the Hawaii statute is judged by an objective standard suitable for class certification. The court noted that "the overall standard of review is for abuse of discretion" when class certification is on appeal, but that a literal interpretation of this standard would conflict with the now bedrock U.S. Supreme Court precedent of *Salve Regina College v. Russell* (1991) that all issues of law must be reviewed de novo. Accordingly, the appellate court held that "underlying rulings on issues of law must be reviewed de novo even when they are made in the course of determining whether or not to certify a class."



*Standard of review in tighter squeeze*

In a concurring opinion, Judge Smith agreed with the result but criticized the majority for its unnecessary departure from the "abuse of discretion" standard. Judge Smith reasoned that the district court's interpretation of the Hawaii Act was an error of law which "is per se an abuse of discretion." Thus, in Judge Smith's view, the abuse of discretion standard was sufficient to resolve the case.

## Three Justices Concerned Over Class Notification Costs

BY TODD FULLER

The U.S. Supreme Court recently denied certiorari of a New Jersey trial court's order, which directed a class action defendant to pay the entire cost of class notice based on the relative wealth of the parties. In *DTD Enterprises, Inc. v. Wells*, a dating-referral service, DTD, sued one of its customers in New Jersey state court for failure to make payments due under their contract. The customer answered with a class action against DTD. The trial court certified the class and ordered DTD to bear the class notification costs apparently on the sole ground that it could afford to pay while the plaintiff could not. DTD petitioned the Supreme Court for a writ of certiorari raising due process claims.

Although the Supreme Court ultimately denied DTD's petition, Justice Kennedy issued a rare explanatory statement, joined by Chief Justice Roberts and Justice Sotomayor, that "[t]o the extent that New Jersey law allows a trial court to impose the onerous costs of class notification on a defendant simply because of the relative wealth of the defendant and without any consideration of the underlying merits of the suit, a serious due process question is raised." Justice Kennedy noted that, under the circumstances, a defendant would have little hope of recovering its expenditures if the suit later proved meritless, and, thus would be deprived of a property interest protected by the Due Process Clause. He added that "there is considerable force to the argument that a hearing in which the trial court does not consider the underlying merits of the class-action suit is not consistent with due process because it is not sufficient, or appropriate, to protect the property interest at stake." The three justices nonetheless agreed with the Court's denial of certiorari because the appeal was interlocutory, and the action was automatically stayed when DTD filed for bankruptcy.

## Arbitration Roundup

BY LANDON CLAYMAN

In recent years, the law of unconscionability frequently has provided the basis for revoking an arbitration agreement under Section 2 of the Federal Arbitration Act. The familiar test in many jurisdictions is that to be invalidated for unconscionability, a contract must be found to be both procedurally and substantively unconscionable. Procedural unconscionability usually is held to involve the manner in which the contract was entered into, whether the complaining party had a meaningful choice and opportunity to bargain regarding the terms of the contract, or was presented the contract on a take-it-or-leave-it basis. With such criteria, many consumer contracts, which cannot reasonably be negotiated individually in our mass production and mass consumption society, often are automatically found to be procedurally unconscionable, leaving only the question of whether the contract is substantively unconscionable.

*Credit card agreements in question in Eighth Circuit*

In *Cicle v. Chase Bank USA*, a recent decision of the U.S Eighth Circuit Court of Appeals involving claims relating to a Chase credit card, the court recognized that it would be unworkable, and much of commerce would screech to a halt, if all credit card agreements, and similar take-it-or leave-it agreements between consumers and businesses that are used all the time in today's business world, were deemed unconscionable and unenforceable contracts of adhesion. The court reversed an order that denied a motion to compel arbitration and that held a class arbitration waiver to be unconscionable. Applying Missouri law, the Eighth Circuit ruled that elements of procedural and substantive unconscionability must be considered together, and balanced, so that, if there is gross procedural unconscionability, not much will be needed in the way of substantive unconscionability, and vice versa. Thus, although the court found there was an aspect of procedural unconscionability in the credit card agreement because of Chase's superior bargaining position and the lack of opportunity for negotiation, it was not sufficient to render the agreement unenforceable unless the agreement was grossly unconscionable in substance.

This flexible approach of balancing the procedural and substantive elements of unconscionability doctrine is preferable to a rigid standard that automatically brands most consumer contracts as procedurally unconscionable, simply because the terms of the contract were not individually negotiated with consumers.

# NEWS & NOTES

## Speeches and Publications

**Steve Kass**, Partner in the Miami office, spoke at PLI Conference in New York City on January 4-5, 2010. He discussed "Current Developments in Life Insurance and Annuities."

**Joan Boros**, of Counsel in the Washington, DC office, co-chaired PLI's Seminar on Securities Products of Insurance Companies in the Face of Regulatory Reform 2010. The seminar detailing new legislation and regulations took place in New York City on January 29, 2010.

**Joan Boros** also wrote "A Tale of New Retirement Products" in the January 18, 2010 issue of Investment News.

**Sheila Carpenter**, Partner in the Washington, DC office, authored "5th Circuit Rules En Banc That Arbitration Treaty Trumps State Insurance Laws," in the Harris Martin Reinsurance Report, December 2009 issue.

For the Connecticut Law Tribune, **James Sconzo** and **Jonathan Sterling**, Partner and Associate, in the Connecticut office, wrote "Getting the Message About E-mail Monitoring." The article was published in the January 25, 2010 edition.

**Rollie Goss**, Partner in the Washington, DC office, authored, "Court of Appeal Addresses Preclusive Effect of Collusive Foreign Court Judgments," in the Harris Martin Reinsurance Report, November 2009 issue.

## *Congratulations!*

Jorden Burt is pleased to announce that **Kristin A. Shepard** has been elected partner, effective January 1, 2010. Kristin (Washington, DC office), focuses her practice on representing insurance and financial services companies in class action and other high-impact litigation at both the trial and appellate court levels, throughout the United States. Kristin received her J.D. and her B.A., summa cum laude, from Washington University.

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