



2012 INSURANCE & REINSURANCE LAW REPORT

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THE PRECLUSIVE EFFECT OF INSURANCE DEPARTMENT APPROVALS OF RESTRUCTURING TRANSACTIONS: LESSONS FROM THE MONOLINE MELTDOWN

BY WILLIAM M. SNEED

The turmoil in the financial markets over the past four years has had a profound effect on financial guaranty (“monoline”) insurers. Most of these monoline insurers traditionally focused on the insurance of municipal bond obligations. That business segment, while not completely free from major losses, continues to be a viable one. Many of the monolines, however, expanded their focus during the first decade of the new century and began to write insurance on the obligations of issuers of structured finance products, including securities backed by residential and commercial mortgages. As is well known, the results in that sector have been disastrous.

As a result, many monolines have restructured their businesses. Among the largest restructurings are:

- *MBIA*: This company, the world’s largest monoline, voluntarily restructured its business under the supervision of the New York State Insurance Department, as more fully described in this article.
- *Ambac*: In a court-approved restructuring, this Wisconsin-domiciled monoline divided its business into a “Segregated Account” and a continuation of the existing corporation. The former holds its structured finance business along with some public finance policies having suffered losses, while the latter holds the traditional public finance business. The parent corporation, Ambac Financial, is in Chapter 11 reorganization.
- *FGIC*: This New York-domiciled monoline is in Chapter 11 reorganization. A prepackaged plan of reorganization became impractical due to the failure of an exchange offer and, as of February 2012, the company will lose the exclusive right to propose a reorganization plan for itself.
- *ACA*: Under the supervision of the Maryland Insurance Administration, ACA is conducting its business as a runoff (with new management) of its public finance policies, after resolving the claims of credit default swap counterparties (including the issuance to those counterparties of non-interest bearing surplus notes).
- *Syncora*: Like ACA, the New York-domiciled Syncora has settled the claims of its major structured finance creditors. It has also monetized various of its assets and begun to rebuild its policyholders’ surplus, in order to recommence payment of claims, which had been suspended pursuant to an order of the New York Insurance Department.

These transactions inevitably invite the question: Does the approval of a restructuring by a state Insurance Department shield the company from policyholder lawsuits complaining about the restructuring transaction’s effects?

Earlier this year, in the context of the MBIA restructuring, the New York Court of

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The Court's decision offers guidance on what circumstances could bolster a claim that state Insurance Department approval has preclusive effect on private rights of action.

Appeals answered: “No.” The Court held that the New York Insurance Superintendent’s approval of the MBIA restructuring transactions did not mandate dismissal of fraudulent conveyance and other claims by certain MBIA policyholders. The Court’s decision offers guidance on what circumstances could bolster a claim that state Insurance Department approval has preclusive effect on private rights of action.

THE MBIA RESTRUCTURING

MBIA Inc. announced its restructuring plan in February 2008, as the financial crisis was unfolding. The plan concerned financial guaranty policies issued by its subsidiary, MBIA Insurance Corporation (“MBIA Insurance”). Those policies stemmed from two main lines of business: (1) municipal bonds and other securities issued by public entities (“public entity business”), and (2) structured finance products, such as mortgage-backed securities or collateralized debt obligations (“structured finance business”). MBIA Insurance had issued financial guaranty policies on public entity business with a face value of approximately \$554 billion and on the structured finance business with a face value of approximately \$233 billion.

The restructuring transactions involved the following steps:

- MBIA Insurance paid a \$1.147 billion dividend to its parent company, MBIA Inc.
- MBIA Insurance redeemed approximately one-third of its capital stock held by MBIA Inc. in exchange for (a) approximately \$938 million in cash and securities from MBIA Insurance, and (b) the stock of MBIA Insurance Corporation of Illinois (“MBIA Illinois”), which had been a subsidiary of MBIA Insurance.
- MBIA Inc. transferred the assets it had received from MBIA Insurance, including the stock in MBIA Illinois, to a wholly-owned subsidiary, MuniCo Holdings, Inc. (“MuniCo”).
- MuniCo capitalized MBIA Illinois by contributing the \$2.085 billion in cash and securities received from MBIA Inc.
- MBIA Illinois reinsured nearly all of the public entity business of MBIA Insurance on a cut-through basis, such that the policyholders could seek recovery directly from MBIA Illinois. In exchange, MBIA Insurance paid MBIA Illinois approximately \$3.66 billion.
- MBIA Illinois would administer and service the public entity business it reinsured.

As a consequence of this restructuring, the structured finance business would remain with MBIA Insurance, while the public entity business would be covered by MBIA Illinois (which was re-named National Public Finance Guarantee Corporation). MBIA Insurance applied to the Superintendent of the New York State Insurance Department for approval or non-disapproval respecting various aspects of the restructuring transactions.¹ For example, New York Insurance Law § 4105(a) applied to the proposed dividend and required Superintendent approval based upon

¹ Illinois insurance regulators were also involved in approving some aspects of the restructuring transactions.

a finding “that the [dividend-paying] insurer will retain sufficient surplus to support its obligations and writings.” New York Insurance Law § 1505(a) and (d) required that transactions within an insurance holding company system be fair and equitable, and that a reinsurance agreement between an insurer and any person in its holding company system be notified to and “not disapproved” by the Superintendent. New York Insurance Law § 1411(d) provides that no domestic stock insurer shall purchase its own capital shares except pursuant to “... a plan of stock redemption and retirement approved by the superintendent as reasonable and equitable.”

In a letter dated February 17, 2009, the Superintendent approved the stock redemption as “reasonable and equitable” and did not disapprove the reinsurance transaction. For each determination, the Superintendent stated that he relied on the truth of MBIA Insurance’s representations in its application and other submissions. MBIA Inc., MBIA Insurance and MBIA Illinois consummated the restructuring transactions on the same day that the Superintendent issued his letter.

On the next day, the Superintendent issued a press release announcing that the Superintendent had overseen a “transformation of [MBIA Insurance] that effectively splits that company in two, dividing its assets and liabilities between two highly capitalized insurance companies.” The Superintendent also stated that both MBIA Insurance and MBIA Illinois would continue to pay all valid claims in a timely fashion and that “both entities will have sufficient resources to meet policyholder claims as they come due.”

THE LAWSUIT AND THE COURT DECISIONS

Three months later, various institutions holding financial guaranty policies from MBIA Insurance sued MBIA Inc., MBIA Insurance and MBIA Illinois in the New York state court. These plaintiffs, who were policyholders respecting structured finance business, alleged fraudulent conveyance claims under New York statutes, along with common law claims for breach of the implied covenant of good faith and fair dealing and unjust enrichment. They sought a declaration piercing the corporate veil. They also asked the trial court to invalidate the transfer of assets out of MBIA Insurance, or alternatively to declare that the defendants were jointly and severally liable to the plaintiffs under their MBIA Insurance policies. The main thrust of the Complaint was that the restructuring transferred about \$5 billion from MBIA Insurance to MBIA Illinois, allegedly rendering MBIA Insurance insolvent. The plaintiffs did not allege any failure by MBIA Insurance to pay any claim.

The defendants moved to dismiss, arguing that the plaintiffs’ action was an impermissible collateral attack on the Superintendent’s February 2009 decision, which could be challenged only in an Article 78 proceeding.² The defendants also moved to dismiss the Complaint for failure to state a cause of action. In response to the collateral attack argument, the plaintiffs contended that they were

² “Article 78” is Article 78 of the New York Civil Practice Law and Rules, which governs cases brought against a governmental “body or officer,” such as the Superintendent. Article 78 sets forth the procedures to be followed to challenge a determination by a body or officer, as well as the standard of review respecting such determinations. Six days after the defendants moved to dismiss, the plaintiffs filed an Article 78 petition naming the Superintendent and the defendants as respondents. The plaintiffs claimed that the Superintendent acted arbitrarily and capriciously, abused his discretion and exceeded his authority by issuing the February 2009 letter and making the determinations therein.

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not challenging the Superintendent's approval of the restructuring plan. Instead, they claimed that they were creditors asserting their rights as creditors.

The trial court rejected the argument that the Superintendent's approval foreclosed the action: "The mere fact that there was earlier approval of the MBIA restructuring by the Insurance Department does not immunize defendants from subsequent statutory and common law claims."³ The court found that the plaintiffs were not asking the court to determine whether the Superintendent correctly interpreted and applied the state insurance laws. "Instead, the focus here is on the intent and conduct of defendants in stripping away assets and shielding them from the legitimate claims of the corporate creditor." The court contrasted the decision in *Fiala v. Metropolitan Life Ins. Co.*,⁴ where the court found that a policyholder's challenge to the Superintendent's approval of MetLife's demutualization plan was properly dismissed as an impermissible collateral attack on the Superintendent's determination.

According to the court, *Fiala* "involved consideration of insurance laws, whereas the cause of action here is partially based on other statutory claims involving Debtor and Creditor law and the common law." Also, the *Fiala* decision found that certain claims against MetLife (stemming from the alleged preferential treatment of one policyholder) were not foreclosed by the Superintendent's approval because there was no indication that the Superintendent was aware of the alleged preferential treatment when he passed upon the demutualization plan.

In addition, the court emphasized that the Insurance Department's private review in the MBIA case differed from the approval of the MetLife demutualization plan. For MetLife, the Superintendent was required to make a determination after notice, a hearing, and a policyholder vote, whereas the MBIA approval letter released by the Insurance Department "was issued without any notice or a public hearing."

The defendants appealed, and the Appellate Division reversed in a 3-2 decision.⁵ With respect to the fraudulent conveyance causes of action, which were based on the New York Debtor and Creditor Laws, the court found that these claims should have been dismissed as improper collateral attacks on the Superintendent's determinations made in the exercise of his regulatory authority. The court agreed that the appropriate vehicle for challenging the Superintendent's determination was an Article 78 proceeding. The court cited favorably to the *Fiala* decision and found the lack of notice and a public hearing irrelevant: "In any event, plaintiffs have not been deprived of the opportunity to be heard, since their article 78 proceeding enables them to challenge the Superintendent's approval and the restructuring." The court examined the plaintiffs' specific allegations respecting fraudulent conveyance (that MBIA Insurance did not receive fair consideration for transferring its assets, that the transfer left MBIA Insurance with unreasonably small capital, and that defendants intended to hinder, delay and defraud MBIA Insurance's structured finance policyholders) and found that they directly conflicted with the Superintendent's determination that MBIA Insurance would retain sufficient surplus following the restructuring. The court stressed that the plaintiffs sought to reverse the dividend, stock redemption and reinsurance transactions that comprised

³ *ABN AMRO Bank, N.V. v. MBLA Inc.*, 26 Misc. 3d 1223A, 907 N.Y.S.2d 435 (2010)

⁴ 6 A.D.3d 320, 776 N.Y.S. 2d 29 (2004)

⁵ *ABN AMRO Bank, N.V. v. MBLA Inc.*, 81 A.D.3d 237, 916 N.Y.S.2d 12 (2011). The dissenting opinion would have affirmed the trial court in all respects, except for dismissing the unjust enrichment claim.

the restructuring, even though the Superintendent had specifically approved those transactions. “Accordingly, the only appropriate vehicle for plaintiffs’ claims is their proceeding pursuant to CPLR article 78.”⁶

The plaintiffs appealed. In a 5-2 decision, the Court of Appeals reversed in all respects (except that it affirmed the dismissal of the unjust enrichment claim).⁷ The Court of Appeals analyzed the issue in terms of jurisdiction. The New York Constitution establishes the Supreme Court (trial court) as a court of general original jurisdiction competent to entertain all causes of action unless its jurisdiction has been specifically proscribed. The Legislature, however, can confer exclusive original jurisdiction upon an agency in connection with the administration of a statutory regulatory program. The question, therefore, was whether the Legislature intended to vest the Superintendent with exclusive original jurisdiction to approve the MBIA restructuring, “including claims that the restructuring rendered MBIA Insurance insolvent and was unfair to its policyholders.” The Court of Appeals found no such intent, concluding “that there is no indication in the statutory language and structure of the Insurance Law or its legislative history that the Legislature intended to give the Superintendent such broad preemptory power...”. After finding no such intent, the Court of Appeals then considered the issue in terms of administrative collateral estoppel — whether the Superintendent’s determinations were binding on the plaintiffs. The Court of Appeals readily found that they were not, as collateral estoppel requires a “full and fair opportunity to contest the decision now said to be controlling” and there had been no such opportunity for the plaintiffs: no notice to the plaintiffs and no public hearings. Although the Superintendent complied with lawful administrative procedure in this regard, the Court of Appeals found that this did not alter the result.

After concluding that the plaintiffs’ claims were not barred by the Superintendent’s approval, the Court of Appeals analyzed the individual claims to determine whether they stated a cause of action. Except for the unjust enrichment claim, the Court of Appeals found that the plaintiffs did state causes of action.⁸

LESSONS

The MBIA decisions illustrate the competing viewpoints on the effect of Insurance Department approval of a transaction, and they also highlight the specific circumstances that bear on whether a determination will have preclusive effect. The Appellate Division and Court of Appeals treatment of the issue appear to be polar opposites.

However labeled, the basic doctrines at play are jurisdiction and administrative collateral estoppel. Are the claims at issue relegated to the forum of the Insurance Department? And, was there a fair opportunity to “litigate” those claims in that forum? The Court of Appeals answered in the negative on both questions, noting

⁶ With respect to the common law claims, the court found that they failed to state causes of action. Here, the court relied upon the particular elements of the common law claims to find that plaintiffs’ allegations fell short. The main problem, according to the court, was that the plaintiffs did not allege that they had suffered any injury because MBIA Insurance had not yet failed to pay any claim.

⁷ *ABN AMRO Bank, N.V. v. MBIA Inc.*, 17 N.Y.3d 208, 952 N.E.2d 463 (2011)

⁸ A different set of plaintiffs filed a similar action against the MBIA defendants in federal court. The court denied the MBIA defendants’ motion to dismiss the case based on the collateral attack doctrine and for failure to state claims upon which relief could be granted. The court also denied the defendants’ request that the court abstain from exercising jurisdiction during the pendency of the related proceedings in the state court. *Aurelius Capital Master, Inc. v. MBIA Ins. Corp.*, 695 F.Supp. 2d 68 (S.D.N.Y. 2010).

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on the first question the lack of any indication in the insurance laws that private fraudulent conveyance claims were preempted, and pointing out on the second question that there was no opportunity at all for the plaintiffs to litigate their claims before the Superintendent.

Although the Appellate Division did not structure its analysis along the lines set forth by the Court of Appeals, implicit in its decision was the concept that jurisdiction rested with the Superintendent because the insurance laws vested full regulatory authority over the business of insurance in the Superintendent, including solvency determinations. According to the court, to the extent a private action challenges determinations the Superintendent has made, the action is an impermissible indirect challenge to the Superintendent's decision, which must be made in an Article 78 proceeding. The Appellate Division stressed that the essence of the fraudulent conveyance claims — that the transactions allegedly rendered MBIA Insurance insolvent — was necessarily in conflict with the Superintendent's determination that the transactions left MBIA Insurance with the wherewithal to meet policyholder claims as they become due. As for the fair opportunity to "litigate" question, the Appellate Division relied on the ability to litigate in the Article 78 proceeding, changing the question from whether there had been a fair opportunity to "litigate" the claims before the Superintendent to whether there was a fair opportunity to litigate in the future. In this way, the Appellate Division arguably confined its analysis to a question of jurisdiction: once the court found that the fraudulent conveyance claims implicated the Superintendent's jurisdiction, the plaintiffs' only avenue to challenge the exercise of that jurisdiction was through the Article 78 process.

There is a line of cases addressing the issue of the preclusive effect of an Insurance Department approval on private claims (typically, claims of policyholders, but also claims of insurance company competitors), but not a long line.⁹ The cases vary based on the state law involved and the particular way the arguments are packaged, but some commonalities emerge in terms of how the preclusive effect issue is analyzed.

First, is there a basis to find a legislative intent to vest exclusive jurisdiction in the Insurance Department? This inquiry is largely directed at the statutes describing the Insurance Department's authority. The Court of Appeals in the MBIA case noted the lack of any indication of such jurisdiction in the insurance laws or the corresponding legislative history; but the dissenting opinion noted that such intent may be implied from the nature of the subject matter being regulated, as well as the scope of the state legislative scheme.¹⁰ This latter formulation provides ample room for argument in any given case. For instance, the Appellate Division in the MBIA case highlighted the Superintendent's regulation of insurer solvency. The Court of Appeals rejected that argument because it swept too broadly, while contrasting

⁹ See, e.g., *Ciamachelo v. Independence Blue Cross*, 909 A.2d 1211 (Pa. 2006) (putative class action claim challenging non-profit status of health plan; defendant moves to dismiss, arguing that Pennsylvania Department of Insurance has exclusive jurisdiction); *LaFarge Corp. v. Commonwealth of Pennsylvania, Ins. Dep't*, 7535 A.2d 74 (Pa. 1999) (upholding Insurance Department's approval of plan for restructure and division of CIGNA); *AICCO, Inc. v. Insurance Co. of N. Am.*, 90 Cal. App. 4th 579 (2001) (respecting competitors' California law unfair competition claims arising out of CIGNA restructuring); *Doyle v. Union Ins. Co.*, 277 N.W.2d 36 (Neb. 1979) (respecting Insurance Department's approval of bulk reinsurance transaction, and impact on mutual policyholder's claims against directors for breach of fiduciary duty); *Rowen v. LeMars Mut. Ins. Co.*, 230 N.W.2d 905 (Iowa 1975) (respecting derivative and class action by mutual policyholders against alleged corporate insiders based on transfer of control of an insurer, and whether Insurance Department has primary jurisdiction over such claims).

¹⁰ *ABN AMRO Bank, N.V. v. MBIA Inc.*, 17 N.Y.3d 208, 232, 952 N.E.2d 463, 477 (2011)

the case before it with the demutualization at issue in *Fiala*. Some courts reject *exclusive* jurisdiction in the Insurance Department, but accept *primary* jurisdiction there, with the net effect being that the court can suspend its consideration of certain issues implicating regulatory expertise, pending referral to the Insurance Department for its views.¹¹

Second, what relief are the plaintiffs seeking in their court action? The more the relief sought can be characterized as effectively reversing the Insurance Department's approval, the more likely the finding that the plaintiffs' action is an impermissible collateral attack on the regulator's determination. The Appellate Division in the MBIA case noted that the essence of the plaintiffs' fraudulent conveyance claims was the allegation that the transactions rendered MBIA Insurance insolvent, but the Superintendent's approval necessarily found to the contrary. The Court of Appeals found otherwise. The point is that the framing of the issue is an important part of the analysis. Other courts have considered whether the plaintiffs' claims really touch on technical insurance expertise (such as the fixing of rates), as opposed to common law tort concepts.¹²

Third, what did the Insurance Department say in its approval? The more detailed the approval order and the more explicit it is in determining particular facts, the more likely the finding that it precludes subsequent claims. The more equivocal it is, the less likely. The Superintendent's approval order in MBIA stated a number of times that the approvals and non-disapprovals were based on the representations made in the application and in reliance on the truth of those representations. The Court of Appeals found this factor quite significant: "Crucially, the Superintendent accepted the truth of defendants' submissions..."¹³

Fourth, what process was available when the Insurance Department was considering the transaction at issue? Did the plaintiffs have notice and an opportunity to be heard? The lack of notice and an opportunity to be heard was a major factor in the Court of Appeals' decision in the MBIA case. If a court approaches the issue from the perspective of whether the elements of collateral estoppel have been met, the absence of notice to and an opportunity to be heard by the plaintiffs before the Insurance Department process is likely to be fatal to the argument that the approval has preclusive effect.

CONCLUSION

There will be more insurer restructurings, more Insurance Department approvals of insurer restructurings, and more cases where private parties contest the effect of restructuring transactions, even though they have been approved. The MBIA decisions provide a framework for assessing the impact of an Insurance Department approval on a private right of action.

11 See, e.g., *Ciamaiello v. Independence Blue Cross*, 909 A.2d 1211, 1218 (Pa. 2006); *AICCO, Inc. v. Insurance Co. of N. Am.*, 90 Cal. App. 4th 579, 594 (2001)

12 See *Rowen v. LeMars Mut. Ins. Co.*, 230 N.W.2d 905, 912 (Iowa 1975)

13 17 N.Y.3d at 227, 952 N.E.2d at 473

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THE CHANGING LANDSCAPE OF INSURANCE REGULATION: A BRIEF LOOK AT THE NEW FEDERAL PARADIGM

BY SARAH HUGHES NEWMAN

The regulation of the insurance industry has traditionally been entrusted to the states. But, in the last few years, the federal government has enacted a series of new federal statutes and regulations, and pursued enforcement initiatives, that impose new requirements on insurance companies and their officers and directors. Insurance company officers and directors need to be aware of these new laws, especially since some of them carry significant criminal penalties — even imprisonment. This article provides a brief overview of this new federal regulatory paradigm, including the Dodd-Frank Act, the Sarbanes-Oxley Act, the Foreign Corrupt Practices Act and requirements for insurance companies dealing with sanctioned nations and entities with terrorist connections. Future editions of the *Insurance and Reinsurance Law Report* will address elements of this new paradigm in greater detail.

I. THE DODD-FRANK ACT

The Dodd-Frank Wall Street Reform and Consumer Protection Act¹ is a wide-ranging financial regulatory reform act enacted on July 21, 2010 in response to the recent financial crisis. Dodd-Frank changes the existing financial regulatory structure, creating a host of new agencies while merging and removing others, to streamline the regulatory process and increase oversight of certain financial institutions.

A. FEDERAL RESERVE SUPERVISION OF INSURANCE COMPANIES

Title I of Dodd-Frank establishes the Financial Stability Oversight Council (“FSOC”) to identify risks to the financial stability of the United States, promote market discipline and respond to emerging threats to the stability of the United States financial markets. The FSOC will be monitoring domestic and international financial regulatory developments, including insurance issues. The FSOC may make recommendations to state insurance regulators to apply new or heightened financial standards.

The FSOC may subject a “nonbank financial company” to supervision by the Federal Reserve if it determines that the company’s material financial distress or failure would threaten the financial stability of the United States. The definition of a “nonbank financial company” would include most U.S. and foreign insurance companies and insurance brokers. The FSOC must consult with an insurance company’s state insurance regulator before deciding whether to subject the company to Federal Reserve supervision. A supervised nonbank financial company will be subject to specific prudential standards and reporting requirements, including risk-based capital requirements and leverage limits, liquidity requirements, risk management requirements and limitations on credit exposure. These requirements may be stricter than the standards imposed by state insurance regulators.

In January 2011, the FSOC published a notice of proposed rulemaking setting forth the specific criteria and analytical framework it will use for designating

¹ Pub. L. 111-203, H.R. 4173.

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nonbank financial companies for supervision by the Federal Reserve.² The proposed framework considers the following six categories:

1. Size;
2. Lack of substitutes for the financial services and products the company provides;
3. Interconnectedness with other financial firms;
4. Leverage;
5. Liquidity risk and maturity mismatch; and
6. Existing regulatory scrutiny.

The first three categories relate to the potential for a firm's distress to "spill over" and affect the broader financial system. The remaining three categories relate to how vulnerable a company is to financial distress.

In October 2011, the FSOC issued a "proposed interpretive guidance" which describes the process for designating nonbank companies as a threat to the U.S. economy. The proposal involves a three-stage review process. In Stage 1, the FSOC will apply a uniform quantitative threshold to identify nonbank financial companies that warrant further review. Companies that have assets greater than \$50 billion and that meet or exceed one of the following financial tests will be flagged for further review:

- \$30 billion in gross notational credit default swaps outstanding.
- \$3.5 billion in derivative liabilities.
- \$20 billion of outstanding loans and bonds issued (debt).
- 15 to 1 leverage as measured by assets to equity.
- 10% ratio of short-term debt to total assets.

Stage 2 involves an analysis by FSOC of the nonbank companies using available public and regulatory information. If the FSOC deems that a nonbank company is sufficiently risky, the FSOC will label the company a "systemically important financial institution" ("SiFi"). In Stage 3, a company labeled a SiFi will then engage in discussions including exchange of written material with FSOC. One significant consequence for an insurance company labeled a SiFi is that insolvency proceedings will be handled by the Federal Deposit Insurance Corporation ("FDIC"), rather than under state insurance insolvency laws.

B. THE FEDERAL INSURANCE OFFICE

Title V, Subtitle A of Dodd-Frank establishes the Federal Insurance Office ("FIO"), a new office within the Treasury Department. While the Federal Insurance Office will not have general regulatory authority over the insurance industry, it will have a significant effect on insurance regulation in the following ways: (1) by recommending supervision by the Federal Reserve for insurance companies it determines to be at risk;

² See, *Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies*, 76 Fed. Reg. 4,555 (Jan. 26, 2011).

While the Federal Insurance Office will not have general regulatory authority over the insurance industry, it will have a significant effect on insurance regulation in the following ways: (1) by recommending supervision by the Federal Reserve for insurance companies it determines to be at risk; (2) by preempting state regulations that conflict with certain international agreements regarding insurance and disfavor foreign insurers; and (3) by making recommendations to Congress that may affect the current insurance regulatory framework.

(2) by preempting state regulations that conflict with certain international agreements regarding insurance and disfavor foreign insurers; and (3) by making recommendations to Congress that may affect the current insurance regulatory framework.

The FIO's primary function is to monitor all aspects of the insurance industry, including identifying issues or gaps in the regulation of insurers that could contribute to a systemic crisis in the insurance industry or the U.S. financial system. The FIO will report on and monitor all lines of insurance, except for health insurance, long-term care insurance and crop insurance. To fulfill this function, the FIO will gather information, including information from state insurance regulators, and use that data to issue reports on the insurance industry. The FIO will have the power to subpoena information from insurance companies and their affiliates, but the submission of such information will not waive any privilege attaching to such information.

The FIO will be responsible for coordinating federal policy on insurance matters, including assisting the Treasury Secretary in negotiating agreements with foreign governments, authorities or regulatory bodies. If a state regulation is inconsistent with one of these agreements and disfavors a foreign insurer, the FIO has the authority to preempt the state regulation.

The FIO is required to issue three sets of reports to Congress. Beginning September 30, 2011, the FIO must annually report to Congress on any preemption actions and the insurance industry in general.³ The FIO must submit reports on the global and U.S. reinsurance markets by September 2012 and January 2013.

Finally, the FIO is required to submit a report to Congress by January 21, 2012 on how to modernize and improve insurance regulation in the United States. This report should consider systemic risk regulation for insurance, capital standards, consumer protection, existing national uniformity of state regulation, regulation of insurers and affiliates on a consolidated basis, international coordination of insurance regulation, costs and benefits of federal regulation of insurance, the feasibility of regulating only certain lines of insurance at the federal level, and the potential consequences of regulating insurance companies on a federal level, including the effect on the operation of the state insurance guaranty fund systems.

Other key functions of the FIO include: (1) monitoring whether traditionally underserved communities and consumers, minorities, and low- and moderate-income persons have access to affordable insurance products, and (2) assisting the Treasury Secretary in administering the Terrorism Risk Insurance Program.

C. SURPLUS LINES INSURANCE REGULATION

Title V, Subtitle B of Dodd-Frank is entitled the *Nonadmitted and Reinsurance Reform Act* (the "NRRA"). Part I of the NRRA addresses surplus lines insurance, while Part II concerns reinsurance.

Under current state insurance laws, policyholders may obtain coverage from insurers that are not licensed in the state (whether U.S. or foreign) when they are unable to purchase the required coverage from licensed insurers. Before placing a risk with a nonadmitted insurer, a surplus lines broker must demonstrate that it has searched the licensed market, and must place coverage only with "eligible" surplus lines insurers. These brokers are responsible for maintaining licenses in each state where any portion of the risk is located, filing affidavits that licensed insurers have

³ The FIO did not issue a report in September 2011, apparently because it has negotiated no international agreements to date.

The NRRA, which became effective on July 21, 2011 (one year later than the rest of Dodd-Frank), simplifies surplus lines compliance by imposing a “home state” for licensing, surplus lines tax payments and compliance filings.

Part II of the NRRA eliminates states’ extraterritorial solvency regulation of U.S. reinsurers.

declined the risk, paying the appropriate surplus lines taxes and maintaining records.

Where a risk is located in more than one state, this triggers confusing and sometimes conflicting state requirements for surplus lines placement, including allocation of taxes. The NRRA, which became effective on July 21, 2011 (one year later than the rest of Dodd-Frank), simplifies surplus lines compliance by imposing a “home state” for licensing, surplus lines tax payments and compliance filings.

The NRRA streamlines surplus lines tax payments by providing that only the insured’s home state may require surplus lines premium taxes. Under the act, “home state” is generally defined as the insured’s principal place of business or an individual’s principal residence. If the entire risk is located outside that state, however, the home state is the state with the greatest percentage of the taxable premium for the insured risk. The NRRA encourages (but does not require) the states to develop an interstate compact to allocate and remit these taxes to the appropriate state.

The NRRA also simplifies compliance by providing that surplus lines insurance is subject only to the requirements of the insured’s home state (except for workers’ compensation coverage). For U.S. surplus lines insurers, states’ eligibility criteria must conform to the NAIC Nonadmitted Insurance Model Act or its equivalent. States may not prohibit brokers from placing insurance with a foreign surplus lines insurer listed on the NAIC Quarterly Listing of Alien Insurers.

Finally, the NRRA eliminates state requirements for a due diligence search for coverage sought by an “exempt commercial purchaser” as long as (1) the broker discloses that the coverage may or may not be available in the admitted market, and (2) the commercial purchase requests such nonadmitted coverage in writing.

D. REINSURANCE REGULATION

Part II of the NRRA eliminates states’ extraterritorial solvency regulation of U.S. reinsurers.

Under state insurance laws, a U.S. cedent is authorized to take financial statement credit for ceded reinsurance, so long as the assuming reinsurer satisfies the state’s “credit for reinsurance” requirements. Some states impose these requirements on all insurers licensed (not just admitted) in the state. The NRRA prohibits a state from denying credit for reinsurance if the insurer’s domiciliary state (1) recognizes credit for reinsurance for the ceded risk, and (2) is an NAIC-accredited state or has substantially similar solvency requirements.

The NRRA also preempts the application of the non-domiciliary state’s laws if those laws:

- Restrict or eliminate the cedent’s right to arbitrate disputes;
- Require a certain state’s law to govern the terms of a reinsurance contract; or
- Attempt to enforce a reinsurance contract on terms different than those set forth in the contract.

Finally, the NRRA makes the U.S. reinsurer’s state of domicile the sole regulator of the reinsurer’s financial solvency if the state of domicile is an NAIC-accredited

state or has substantially similar solvency requirements. No other state may require the reinsurer to provide additional financial information.

E. REGULATION OF CREDIT DEFAULT SWAPS

Given the intense public scrutiny of credit derivatives, some states have sought to regulate certain types of credit default swaps as insurance. Title VII of Dodd-Frank mandates federal regulation of the derivatives markets, including credit derivatives. Dodd-Frank amends the Commodity Exchange Act and the Securities Exchange Act of 1934 to state that a swap and a security-based swap shall not be considered insurance and thus may not be regulated as insurance under state insurance laws. Any state regulation of credit default swaps would be preempted.

F. STATE REGULATION OF INDEXED ANNUITIES

Indexed annuities guarantee the purchaser's principal and a certain rate of return and offer a chance for additional returns linked to a securities index. Indexed annuities are currently regulated as insurance by the states. While the SEC adopted Rule 151A in December 2008 to regulate indexed annuities as securities under the SEC's jurisdiction, a lawsuit filed by a group of insurance companies has blocked implementation of the rule.

The Dodd-Frank Act preempts the SEC's regulation of indexed annuities and maintains state regulation as insurance as long as these products satisfy applicable standard nonforfeiture laws and applicable suitability requirements.⁴

II. THE SARBANES-OXLEY ACT

In the wake of the collapse of Enron, Worldcom and other corporations, Congress in 2002 enacted the Sarbanes-Oxley Act.⁵ Sarbanes-Oxley set new or enhanced accounting standards for all U.S. public company boards, management and public accounting firms. Sarbanes-Oxley thus applies to any publicly-held insurance company, notwithstanding the primacy of state regulation of the insurance industry. It is therefore useful to restate its principal features here, even though they have become well known since 2002.

Among other requirements, Sarbanes-Oxley:

- Establishes standards for external auditor independence to limit conflicts of interest;
- Mandates that senior executives take individual responsibility for the accuracy and completeness of corporate financial reports;
- Enhances reporting requirements for financial transactions, including off-balance-sheet transactions, *proforma* figures and stock transactions for corporate officers;
- Requires companies to develop internal controls for assuring the accuracy of financial reports and disclosures and mandates both audits and reports on those internal controls;
- Requires timely reporting of material changes in financial condition;

⁴ See Dodd-Frank Act, Title IX, Subtitle I, §989J.

⁵ Pub. L. 107-204.

Sarbanes-Oxley set new or enhanced accounting standards for all U.S. public company boards, management and public accounting firms.

- Provides criminal penalties for manipulating, destroying or altering financial records or interfering with investigations;
- Provides criminal penalties for retaliating against whistleblowers; and
- Increases the criminal penalties associated with white-collar crimes and conspiracies.

A. REPORTING REQUIREMENTS FOR COMPANY OFFICERS

Section 302 of Sarbanes-Oxley mandates a set of internal procedures designed to ensure accurate financial disclosure. The CEO and CFO of the company must certify that the financial statements and other information included in each annual or quarterly company report fairly present the financial condition, results of operations and cash flows of the company. They must also certify that they have designed internal controls to ensure that the information presented is accurate.⁶ The officers must have evaluated the effectiveness of the company's internal controls within 90 days of the report. External auditors must issue an opinion on whether management has maintained effective internal control over its financial reporting. The Act also provides that if a company restates its financials, the company's CEO and CFO "shall reimburse" the company for any bonuses received during the twelve months following the restated period, as well as any stock sale profits earned during those twelve months. There is no requirement of wrongdoing or fault of the officer in the statute.

B. DEVELOPING AND MAINTAINING INTERNAL FINANCIAL CONTROLS

A controversial aspect of Sarbanes-Oxley is Section 404, which requires management and the external auditor to provide an annual report on the adequacy of the company's internal control over its financial reporting. The documentation and testing of these financial controls requires enormous effort and cost.

To help alleviate the costs of compliance, the Public Company Accounting Oversight Board and the SEC released interpretive guidelines in 2007.⁷ The two standards require management to base the scope of its assessment and the evidence gathered on risk, thus giving management wider discretion in its assessment approach. Together, the two standards require management to:

- Assess both the design and operating effectiveness of selected internal controls, related to significant accounts and relevant assertions, in the context of material misstatement risks;
- Understand the flow of transactions, including IT aspects, in sufficient detail to identify points at which a misstatement could arise;
- Evaluate company-level (entity-level) controls, which correspond to the components of the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") framework;
- Perform a fraud-risk assessment;

A controversial aspect of Sarbanes-Oxley is Section 404, which requires management and the external auditor to provide an annual report on the adequacy of the company's internal control over its financial reporting. The documentation and testing of these financial controls requires enormous effort and cost.

⁶ 15 U.S.C. §7241(a)(4).

⁷ See PCAOB Auditing Standard No. 5; 17 CFR Part 241.

- Evaluate controls designed to prevent or detect fraud, including management override of controls;
- Evaluate controls over the period-end financial reporting process;
- Scale the assessment based on the size and complexity of the company;
- Rely on management’s work based on factors such as competency, objectivity and risk; and
- Conclude on the adequacy of internal control over financial reporting.

The costs of complying with Sarbanes–Oxley affects smaller companies disproportionately since there are significant fixed costs involved in completing the assessments. In September 2010, the SEC issued final rule 33-9142, which permanently exempts registrants that are not accelerated filers or large accelerated filers under Rule 12b-2 from complying with Section 404’s requirements.

III. THE FOREIGN CORRUPT PRACTICES ACT

While the Foreign Corrupt Practices Act⁸ (“FCPA”) has been around since 1977, enforcement has increased in the last few years. From 2009 to 2010, the number of investigations brought by U.S. regulators nearly doubled. The U.S. Department of Justice and the U.S. Securities and Exchange Commission are currently pursuing more than 250 investigations. In 2010, eight companies reached settlements, in separate cases, together totaling \$1.6 billion. Those numbers are likely to rise as a result of Dodd–Frank, which provides that whistleblowers can receive bounties of up to thirty percent of monetary sanctions greater than \$1 million.⁹

The Foreign Corrupt Practices Act, prohibits U.S. citizens from offering or promising bribes to foreign government officials, politicians, political parties or state–run businesses in order to keep or obtain business. Offenses carry steep criminal fines of up to \$2 million per violation for corporations. Officers, directors and employees may be given a criminal fine of up to \$250,000 per violation and up to five years in prison. Moreover, an employer cannot pay a fine levied on an individual. The Attorney General or the SEC can also bring a civil action against a company or an officer, director or employee.

It may not always be apparent what constitutes a bribe or “corrupt payment” under the FCPA. For example, a company may engage in promotional activities, such as paying for customers to travel to company facilities for product demonstrations, training programs and conferences. However, if that customer is a state–owned or state–controlled business (which may not be readily apparent), these payments may be construed as bribes in violation of the FCPA.

Because many insurance companies today have operations in foreign nations, including but not limited to overseas sales operations, broker relationships and reinsurance placements, it is important for them to be aware of potential FCPA liabilities. To avoid problems under the FCPA, a well–designed compliance program is essential.

⁸ 15 U.S.C. 78dd-1 *et seq.*

⁹ See Dodd–Frank, Sec. 922(a), codified as 15 U.S.C. § 78u-6; *Final Rule: Implementation of the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934*, SEC Release No. 34-64545; File No. S7-33-10 (adopted May 25, 2011).

While the Foreign Corrupt Practices Act has been around since 1977, enforcement has increased in the last few years.

This should include

- A clearly stated ethics policy specifically prohibiting actions that violate the FCPA and other anti-corruption laws, with appropriate consequences for violations;
- Senior-level oversight of the compliance program;
- Accounting measures to comply with internal controls requirements;
- Extensive vetting and memorializing of foreign agent relationships to avoid improper behavior by business partners;
- Senior management review of agent relationships;
- Frequent training of employees, officers and agents on the obligations and prohibitions of the FCPA and other applicable anti-corruption laws;
- Internal reporting mechanisms permitting secure referral of corruption issues;
- More frequent audits of operations in problematic jurisdictions or sectors of a business; and
- Frequent review and revamping of all FCPA-related policies and procedures.

IV. TRADE SANCTIONS AND ANTI-TERRORISM MEASURES

The federal government maintains a number of sanctions programs against certain nations, including Iran, Cuba, Burma and Sudan, as well as individuals and organizations that support terrorism. The Office of Foreign Assets Control (“OFAC”) in the U.S. Department of the Treasury controls these programs. Insurance companies must be aware of these programs and develop programs to ensure full compliance. Depending upon the program, violations can carry criminal fines of \$50,000 to \$10,000,000 and imprisonment for 10 to 30 years for willful violations.

A. GENERAL SANCTIONS AGAINST DEALINGS WITH TERRORISTS

The federal government maintains a list of known terrorists and narcotics traffickers and individuals, companies and organizations with ties to terrorist nations or organizations. The Specially Designated Nationals (“SDN”) List, available at <http://www.treasury.gov/resource-center/sanctions/SDN-List/Pages/default.aspx>, is over 500 pages long. In general, all United States citizens and businesses are prohibited from any dealings with these individuals and organizations. This includes the following requirements for insurance companies:

- An insurance company that receives an application from an SDN must not issue a policy. If the applicant sends in a deposit, the company must block the payment.

The federal government maintains a number of sanctions programs against certain nations, including Iran, Cuba, Burma, and Sudan, as well as individuals and organizations that support terrorism. The Office of Foreign Assets Control (OFAC) in the U.S. Department of the Treasury controls these programs. Insurance companies must be aware of these programs and develop programs to ensure full compliance.

- If the insurance company discovers that a policyholder is or has become an SDN, the company must contact OFAC Compliance immediately. Insurance companies may want to consider screening software to ensure that no business is done with any SDN.

B. IRAN SANCTIONS

The federal government has maintained a sanctions program against Iran for the last fifteen years. In 2010, Congress enacted the Comprehensive Iran Sanctions, Accountability, and Divestment Act of 2010 (“CISADA”), H.R. 2194, which amended the Iran Sanctions Act of 1996. CISADA prohibits individuals or companies from assisting Iran with importing refined petroleum products into Iran.

CISADA specifically prohibits individuals or entities from “underwriting or entering into a contract to provide insurance or reinsurance for the sale, lease, or provision” of “goods, services, technology, information, or support that could directly and significantly contribute to the enhancement of Iran’s ability to import refined petroleum products.” Sec. 102(a)(3).

The act also includes an exception for insurers who exercise “due diligence in establishing and enforcing official policies, procedures, and controls” to ensure compliance with CISADA. Insurance company officers should ensure that their companies develop and follow such due diligence procedures to avoid liability and sanctions.

V. CONCLUSION

Federal oversight of the insurance industry has increased dramatically in the last few years, creating a new paradigm of regulation for the insurance industry. As a result, insurance company officers and directors must be aware of these new laws and regulations and implement policies and procedures to ensure compliance.

NAIC REINSURANCE COLLATERAL REFORM

BY CHARLENE C. McHUGH

After several years of deliberation, on November 6, 2011, the National Association of Insurance Commissioners (NAIC) passed amendments to its Credit for Reinsurance Model Act and Regulation (Model Law) that allow for the reduction of collateral required to be posted by assuming reinsurers that are neither licensed nor accredited in the ceding insurer's state of domicile (*i.e.*, are "unauthorized" reinsurers). Reduced collateral is also allowed for reinsurance between affiliated ceding insurers and reinsurers.

While unauthorized reinsurers provide significant reinsurance capacity to U.S. ceding insurers, U.S. insurance commissioners do not directly regulate such reinsurers. Rather, most states currently require that, in order for ceding insurers to obtain full financial statement credit for reinsurance placements with unauthorized reinsurers, reinsurance liabilities must be collateralized at 100%. Collateral reform efforts have focused upon reinsurers that, despite not being licensed or accredited, are financially strong and are domiciled in jurisdictions in which the reinsurers are considered well-regulated. As described further below, to post reduced collateral, reinsurers must apply to become "Certified Reinsurers" with a state insurance commissioner and are evaluated based upon their financial strength and reputational history, among other things.

As a threshold matter, note that although the NAIC has passed the amendments to its Model Law, such amendments are not automatically effective in any state. As with all NAIC model laws, before they are binding in a particular state, the amendments would first need to be enacted by the state, either through legislation or by regulation (*i.e.*, promulgated by the state insurance commissioner).

Also, some states, such as Florida,¹ New York, New Jersey and Indiana already have amended their laws to allow for reduced collateral during the time that the NAIC was pursuing its own initiative. It is currently unclear whether or when such states will change their laws to incorporate the final version of the NAIC Model Law. Some states have not taken any steps to reduce collateral requirements. In fact, states are not required to allow for reductions in the amount of collateral posted by unauthorized reinsurers (though ceding insurers in such states could be disadvantaged).² Therefore, it may take some years before a significant number of states adopt reduced collateral arrangements and some states may not allow for them at all.

Further, reinsurers may experience uneven results across states when pursuing reduced collateral arrangements. The Model Law outlines parameters for states that choose to allow reductions in collateral; however, a state is not actually required to permit reductions in collateral. And, under the Model Law, a state insurance commissioner has the *discretion* to defer to a reinsurer's certification in another

¹ Currently, Florida's collateral reduction law applies only to property-casualty reinsurance and not life reinsurance.

² However, states will no longer be able to impose their credit for reinsurance requirements extraterritorially upon ceding insurers licensed (as opposed to domiciled) in the state. Before the NAIC Model Law passed, the federal Nonadmitted and Reinsurance Reform Act (NRRRA) was enacted in July 2010 (effective July 21, 2011), which prohibits a state from denying credit for reinsurance if the ceding insurer's domiciliary state recognizes credit for reinsurance and is an NAIC-accredited state (or has similar financial solvency requirements).

Collateral reform efforts have focused upon reinsurers that, despite not being licensed or accredited, are financially strong and are domiciled in jurisdictions in which the reinsurers are considered well-regulated.

The Model Law outlines parameters for states that choose to allow reductions in collateral; however, a state is not actually required to permit reductions in collateral.

To encourage uniformity and provide guidance during the process, the NAIC will provide advisory support and assistance to states in reviewing Certified Reinsurer Applications.

NAIC accredited jurisdiction (a commissioner may withdraw recognition of the other jurisdiction’s rating or certification at any time), but is not required to defer to another state’s certification. Therefore, it is possible that a reinsurer may be required to submit separate applications in various states in order to avail itself of reduced collateral arrangements with ceding insurers in various states. Finally, while the Model Law gives commissioners discretion to defer to a rating assigned by another state to a Certified Reinsurer, such discretion is not required and, therefore, reinsurers could receive divergent ratings from different state insurance commissioners and their collateral requirements could differ from state to state and (ceding insurer to ceding insurer). To encourage uniformity and provide guidance during the process, the NAIC will provide advisory support and assistance to states in reviewing Certified Reinsurer Applications. It will also provide guidance to states in evaluating which jurisdictions are considered acceptable and as “Qualifying Jurisdictions” (discussed below).

Below is a description of the process for reducing collateral requirements and certification of reinsurers under the Model Law.

ASSIGNED RATINGS

Under the Model Law, the amount of collateral required of unauthorized reinsurers will depend on a “rating” assigned to the reinsurer by a state insurance commissioner as indicated in the first two columns below. (The maximum rating that a Certified Reinsurer can receive corresponds to its financial strength rating set forth in the third and fourth columns):

Reinsurer’s Rating Assigned by Insurance Commissioner	Collateral Required	Best’s Financial Strength Rating	S&P, Moody’s and Fitch Financial Strength Rating
Secure-1	0%	A++	AAA; Aaa; AAA
Secure-2	10%	A+	AA+, AA, AA- Aa1, Aa2, Aa3 AA+, AA, AA-

Reinsurer's Rating Assigned by Insurance Commissioner	Collateral Required	Best's Financial Strength Rating	S&P, Moody's and Fitch Financial Strength Rating
Secure-3	20%	A	A+, A A1, A2 A+, A
Secure-4	50%	A-	A- A3 A-
Secure-5	75%	B++, B+	BBB+, BBB, BBB- Baa1, Baa2, Baa3 BBB+, BBB, BBB-
Vulnerable -6	100%	B, B-C++, C+, C, C-, D, E, F	BB+, BB, BB-, B+, B, B-, CCC, CC, C, D, R Ba1, Ba2, Ba3, B1, B2, B3, Caa, Ca, C BB+, BB, BB-, B+, B, B-, CCC+, CC, CCC-, DD

As discussed below, to obtain a rating, the reinsurer first applies with a state insurance commissioner to become a Certified Reinsurer. The commissioner's rating is on a legal entity basis (stand-alone, separate from its parent or affiliates), although consideration will be given to a group rating where appropriate. The rating assigned to a reinsurer will depend in part on its financial strength rating assigned by the rating agencies, Standard & Poor's, Moody's, Fitch, A.M. Best or any other Nationally Recognized Statistical Rating Organization. The reinsurer must maintain ratings from two or more of such agencies and, in assigning a rating (Secure-1, 2, *etc.*), the state regulator must use the lower of the two ratings received by the reinsurer.

Additional factors that can affect a regulator's rating of a reinsurer include:

- The reinsurer's business practices, including history of complying with contractual terms and obligations.
- For U.S.-domiciled reinsurers, annual statement information concerning reinsurance transactions. For non-U.S. reinsurers, similar information provided on NAIC Forms CR-F and CR-S (relating to property-casualty and life insurance, respectively).
- The reinsurer's reputation for paying claims promptly. A reinsurer's rating can be adjusted downward depending on the timing and amount of overdue reinsurance recoverables.
- Regulatory actions against the reinsurer.
- Independent auditor reports on financial statements of the insurance enterprise. For non-U.S. reinsurers, audited financial statements, regulatory filings and actuarial opinions filed with the reinsurer's jurisdiction.³
- Whether obligations owed to ceding insurers are given priority under liquidation laws of the reinsurer's domiciliary jurisdiction.
- A reinsurer's participation in a solvent scheme of arrangement or similar procedure involving U.S. ceding insurers. (A Certified Reinsurer must provide prior notice of such participation to state insurance commissioners).
- Any other information deemed relevant to a state insurance regulator.

CERTIFICATION PROCEDURE

To qualify for reduced collateral, a reinsurer must apply to a state insurance commissioner to become a Certified Reinsurer. State insurance department websites must publish notice of applications received for certification and a list of reinsurers that have been certified (and their assigned ratings). In addition to the rating requirement described above, to be eligible for certification, the reinsurer must be domiciled and licensed to transact insurance or reinsurance in a Qualified

³ Audited U.S. GAAP financial statements are required, if available; otherwise, either audited International Financial Reporting Standards (IFRS) basis statements are filed along with either audited footnotes that reconcile equity and net income to a U.S. GAAP basis or a certification of a reinsurer's officer concerning reconciliation to U.S. GAAP.

Jurisdiction (discussed below) and maintain minimum capital and surplus of \$250,000,000.

Following certification, the reinsurer must maintain its certification by submitting financial statements, agreeing to submit to state jurisdiction and appointment of the commissioner as agent for service of process, and acknowledging that the reinsurer will provide security for 100% of liabilities attributable to reinsurance ceded by U.S. ceding insurers if it resists enforcement of a final U.S. judgment. The reinsurer must also satisfy periodic filing requirements, including:

- notification of regulatory actions against the reinsurer, or licensing or ratings changes;
- certification from the reinsurer's domestic regulator that it is in good standing and adequately capitalized;
- annual filings of Form CR-F or CR-S, as applicable, independent auditor's reports and audited financial statements, regulatory filings and actuarial opinions; and
- periodic lists of all disputed and overdue reinsurance claims regarding reinsurance assumed from U.S. domestic ceding insurers.

QUALIFIED JURISDICTIONS

A Certified Reinsurer must be domiciled and licensed to transact insurance or reinsurance in a "Qualified Jurisdiction." Whether a jurisdiction is "qualified" is determined by each state's insurance commissioner, which must evaluate the reinsurance supervisory system of a non-U.S. jurisdiction and the extent of reciprocal recognition afforded by that non-U.S. jurisdiction to U.S.-domiciled reinsurers. A Qualified Jurisdiction must also agree to share information and cooperate with a state insurance commissioner with respect to all Certified Reinsurers domiciled within the Qualified Jurisdiction.

The following factors may also be considered by a regulator in determining whether to recognize a Qualified Jurisdiction:

- the regulatory framework under which the reinsurer is regulated;
- the structure and authority of the domiciliary regulator with respect to solvency regulation requirements and financial surveillance;
- the financial and operating standards for assuming insurers in the domiciliary jurisdiction;
- the form and substance of financial reports filed in the reinsurer's domiciliary jurisdiction and accounting principles used;
- the domiciliary regulator's willingness to cooperate with U.S. regulators in general and the commissioner in particular;
- the history of performance by the reinsurer in its domiciliary jurisdiction;

Following certification, the reinsurer must maintain its certification by submitting financial statements, agreeing to submit to state jurisdiction and appointment of the commissioner as agent for service of process, and acknowledging that the reinsurer will provide security for 100% of liabilities attributable to reinsurance ceded by U.S. ceding insurers if it resists enforcement of a final U.S. judgment.

Whether a jurisdiction is "qualified" is determined by each state's insurance commissioner, which must evaluate the reinsurance supervisory system of a non-U.S. jurisdiction and the extent of reciprocal recognition afforded by that non-U.S. jurisdiction to U.S.-domiciled reinsurers.

- problems with enforcement of U.S. judgments;
- mutual recognition of reinsurance supervision adopted by the International Association of Insurance Supervisors or successor organization; and
- any other factors deemed relevant by the insurance commissioner.

Notably, the NAIC must publish a list of Qualified Jurisdictions and has begun work through the NAIC committee process to evaluate potential jurisdictions and formulate a list. Under the Model Law, state insurance commissioners must consider the NAIC list in determining whether a jurisdiction is to be qualified. On the other hand, if a commissioner approves a jurisdiction that is *not* on the NAIC list, justification for the decision must be well-documented.

ADDITIONAL REQUIREMENTS AND LIMITATIONS

The Model Law outlines certain limitations on the ability to post reduced collateral. For example, even a Certified Reinsurer must post 100% collateral for the benefit of the ceding insurer upon the ceding insurer becoming subject to an order of rehabilitation, liquidation or conservation. Also, credit for reinsurance under the reduced collateral provisions in the Model Law applies only to reinsurance contracts entered into or renewed on or after the effective date that the reinsurer became a Certified Reinsurer. Reinsurance contracts entered into before the effective date that are subsequently amended after the effective date (or a new reinsurance contract) covering any risk for which collateral was provided previously, are only subject to the reduced collateral with respect to losses incurred and reserves reported from and after the effective date of the amendment (or new contract). Also, a ceding insurer must notify its domestic regulator if reinsurance ceded to an individual reinsurer (or group of affiliated reinsurers) exceeds certain specified amounts.

With respect to concentration of risk, a ceding insurer must notify its domiciliary commissioner within 30 days after reinsurance recoverables from any single assuming reinsurer (or group of affiliated assuming reinsurers) exceeds 50% of the ceding insurer's last reported policyholder surplus, or after it is determined that reinsurance recoverable from any single assuming reinsurer (or group of affiliated assuming reinsurers) is likely to exceed this limit.

With respect to concentration of risk, a ceding insurer must notify its domiciliary commissioner within 30 days after reinsurance recoverables from any single assuming reinsurer (or group of affiliated assuming reinsurers) exceeds 50% of the ceding insurer's last reported policyholder surplus, or after it is determined that reinsurance recoverable from any single assuming reinsurer (or group of affiliated assuming reinsurers) is likely to exceed this limit. Ceding insurers must also notify the commissioner within 30 days after ceding to any single assuming reinsurer (or group of affiliated assuming reinsurers) more than 20% of the ceding insurer's gross written premium in the prior calendar year, or after it has determined that the reinsurance ceded to any single assuming reinsurer (or group of affiliated assuming reinsurers) is likely to exceed this limit.

Reinsurance contracts must contain certain clauses, such as an insolvency clause (reinsurance is payable directly to the liquidator or successor without diminution due to the insolvency of the ceding insurer) and a reinsurance intermediary clause (stipulating that the credit risk for the intermediary is carried by the reinsurer).

CONCLUSION

The NAIC's historic vote on collateral reduction should prompt most states that have not already initiated collateral reform initiatives to consider adding collateral reduction features to their credit for reinsurance rules, either through legislation or regulation. However, that process (especially the legislative process) may be prolonged in some states, especially those with infrequent sessions. The legislative process may also serve as another battle ground for opponents and proponents of collateral reduction to state their cases on the issue, further delaying collateral reform. States that already passed and implemented collateral reduction rules will need to decide whether to further amend such rules to conform to the NAIC version in the Model Law. Some states may decide not to reduce current collateral requirements for all or most unauthorized reinsurers, potentially putting ceding insurers domiciled in these states on an uneven playing field with ceding insurers in other states. Finally, it remains to be seen whether states adopting the concept of collateral reform will be willing to work together in a cooperative manner so that an acceptable level of uniformity can be reached for those reinsurers that will move forward with the process of becoming Certified Reinsurers in multiple states.

The NAIC's historic vote on collateral reduction should prompt most states that have not already initiated collateral reform initiatives to consider adding collateral reduction features to their credit for reinsurance rules, either through legislation or regulation.

A NEW BATTLEGROUND IN CLASS ACTIONS: THE COMMONALITY REQUIREMENT OF RULE 23(a)(2)*

BY JEFFREY E. CRANE

The U.S. Supreme Court decision in *Wal-Mart Stores, Inc. v. Dukes*¹ has thrust the commonality requirement of Fed. R. Civ. P. 23(a)(2) onto center stage for class litigation. Class action defendants, including insurance companies, now can argue that plaintiffs have failed to satisfy the new, heightened commonality standards established in *Wal-Mart*. Indeed, defendants have been making that very argument in cases across the country and lower courts have found in favor of defendants on this point with some regularity.

This article examines: (i) the Rule 23(a)(2) standards prior to *Wal-Mart*; (ii) the *Wal-Mart* holding regarding Rule 23(a)(2); and (iii) how future class action litigation will need to adapt to the *Wal-Mart* standard for the Rule 23(a)(2) commonality requirement. Insurers need to know about this new battleground in order to defend putative class actions with the greatest possible effectiveness.

I. PRE-WAL-MART RULE 23(a)(2) STANDARDS

Prior to *Wal-Mart*, federal courts generally treated Rule 23(a)(2) commonality as a low threshold requirement that could be satisfied by identifying a single common question of law or fact.² Rule 23 (a)(2) requires plaintiffs to establish that their claims share a common issue of law or fact with the members of the class they seek to represent.³ However, this Rule 23 requirement “‘does not require that all questions of law or fact raised in the litigation be common.’”⁴ 1 H. Newberg & A. Conte, *Newberg on Class Actions* § 3.10, pp. 3-48 to 3-49 (3d ed. 1992); indeed, ‘even a single question of law or fact common to the members of the class will satisfy the commonality requirement,’ Nagareda, *The Preexistence Principle and the Structure of the Class Action*, 103 Colum. L. Rev. 149, 176, n.110 (2003).”⁴

In all manner of class actions filed in federal courts across the country, Plaintiffs moving for class certification would routinely identify one or more common questions such as:

- whether the defendant violated a statute;
- whether the defendant misled and/or deceived plaintiffs;
- whether the defendant overcharged plaintiffs;
- whether the defendant breached a contract;
- whether the defendant was unjustly enriched by its improper conduct;
and

* Adapted with permission from *Class Action Litigation Report*, 12 CLASS 853, 09/09/2011. Copyright 2011 by The Bureau of National Affairs, Inc. (800-372-1033) www.bna.com.

1 131 S. Ct. 2541 (2011).

2 See, e.g., *Dukes v. Wal-Mart Stores, Inc.*, 603 F.3d 571, 594 (9th Cir. 2010) (plaintiffs’ burden under Rule 23(a)(2) is lower than that under Rule 23(b)(3)); *Williams v. Mohawk Indus., Inc.*, 568 F.3d 1350, 1356 (11th Cir. 2009) (plaintiffs satisfied the “low hurdle of Rule 23(a)(2)”; *Gariety v. Grant Thornton, LLP*, 368 F.3d 356, 366 (4th Cir. 2004) (same as *Dukes*); *Baby Neal For and By Kanter v. Casey*, 43 F.3d 48, 56 (3d Cir. 1994) (“Because the requirement may be satisfied by a single common issue, it is easily met . . .”); 7 Wright, Miller & Kane, *Fed. Prac. & Proc.* § 1653.

3 *Gen. Tel. Co. v. Falcon*, 457 U.S. 147, 156-57 (1982).

4 *Wal-Mart*, 131 S. Ct. at 2562 (Ginsburg, J., dissenting).

Class action defendants, including insurance companies, now can argue that plaintiffs have failed to satisfy the new, heightened commonality standards established in *Wal-Mart*.

- whether the defendant’s unlawful conduct injured plaintiffs and caused damages.

Upon considering such common issues, courts generally would find that plaintiffs had satisfied the relatively simple requirement of identifying at least one common issue of law or fact.⁵ Indeed, defendants would not often seriously challenge “commonality” under Rule 23(a)(2), instead saving their fire for the far more demanding predominance requirement of Rule 23(b)(3).⁶

II. THE HOLDING OF *WAL-MART* REGARDING RULE 23(a)(2)

In *Wal-Mart*, the Supreme Court held that “[c]ommonality requires the plaintiff to demonstrate that the class members ‘have suffered the same injury.’ This does not mean merely that they have all suffered a violation of the same provision of law. . . . Their claims must depend upon a common contention That common contention, moreover, must be of such a nature that it is capable of classwide resolution — which means that determination of its truth or falsity will resolve an issue that is central to the validity of each one the claims in one stroke.”⁷ This central holding of *Wal-Mart* thus establishes a new precedent that it is not enough for the question to be the same for each class member, but that question must be answerable in one fell swoop.

The Supreme Court also found that plaintiffs have the burden of satisfying the Rule 23 requirements based on “significant proof” that can withstand rigorous analysis, and added that “Rule 23 does not set forth a mere pleading standard.”⁸ Plaintiffs brought employment discrimination claims against Wal-Mart and supported their class certification motion by presenting expert testimony, statistical evidence and certain anecdotal evidence. The Supreme Court, however, rejected the expert testimony as unresponsive of plaintiffs’ claims, describing it as “worlds away from ‘significant proof’ that Wal-Mart ‘operated under a general policy of discrimination.’”⁹ As to the plaintiffs’ statistical evidence — regression analyses performed by a statistician and a labor economist — the Supreme Court decided that “[e]ven if they are taken at face value, these studies are insufficient to establish that respondents’ theory can be proved on a classwide basis.”¹⁰ Plaintiffs’ anecdotal evidence consisted of “some 120 affidavits reporting experiences of discrimination—about 1 for every 12,500 class members — relating to only some 235 out of Wal-Mart’s 3,400 stores. . . . Even if every single one of these accounts is true, that would not demonstrate that the entire company ‘operate[s] under a general policy of discrimination,’ which is what respondents must show to certify a companywide class.”¹¹ The Supreme Court thus concluded that “[b]ecause respondents provide no convincing proof of a companywide discriminatory pay and promotion policy, we have concluded that they have not established the existence of any common question.”¹²

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⁵ *Williams*, 568 at 1355–56; *Spann v. AOL Time Warner, Inc.*, 219 F.R.D. 307, 316 (S.D.N.Y. 2003).

⁶ The predominance requirement of Rule 23(b)(3), though redolent of the commonality requirement of Rule 23(a), is far more demanding because it “tests whether proposed classes are sufficiently cohesive to warrant adjudication by representation.” *Amchem Prods., Inc. v. Windsor*, 521 U.S. 591, 623–24 (1997); *Kamar v. Radio Shack Corp.*, 254 F.R.D. 387, 396 (C.D. Cal. 2008) (defendant did not dispute that plaintiffs satisfied commonality under Rule 23(a)); *Spann*, 219 F.R.D. at 316 (defendants did not challenge commonality under Rule 23(a)).

⁷ 131 S. Ct. at 2551 (internal citation omitted).

⁸ *Id.*

⁹ *Id.* at 2554.

¹⁰ *Id.* at 2555.

¹¹ *Id.* at 2556 (internal citations omitted).

¹² *Id.* at 2556–57.

III. HOW FUTURE CLASS ACTION LITIGATION WILL NEED TO ADAPT TO THE *WAL-MART* RULE 23(a)(2) COMMONALITY STANDARD

Without question, the holding and reasoning in *Wal-Mart* raised the bar substantially for plaintiffs seeking class certification. Although *Wal-Mart* was an employment discrimination case, the same Rule 23(a)(2) standards apply to all types of class actions. In some contexts, such as securities class actions, plaintiffs generally can satisfy the pre- and post-*Wal-Mart* commonality requirement by presenting a common issue whether the defendant made a material misstatement or omission in a public disclosure.¹³ However, in other types of class litigation, such as consumer fraud and, perhaps, class actions against insurers, plaintiffs will not necessarily be able to identify a common issue and satisfy Rule 23(a)(2) based on the *Wal-Mart* standard.¹⁴ Indeed, certifying class actions going forward will require plaintiffs to: consider narrowing the scope of certain class definitions, take substantial discovery, present significant evidence and, possibly, participate in mini-trials.

A. CLASS DEFINITION

Plaintiffs will need to reevaluate how they define a class — nationwide or a more tailored, narrowly focused approach. In many but not all cases, plaintiffs might opt for a reduced class size and scope so that they can identify “a common mode of exercising discretion that pervades the entire company.”¹⁵ In employment discrimination cases, plaintiffs probably will have to take a targeted approach that limits the class to a single plant or job classification or a common supervisor. In other types of cases, plaintiffs will need to determine the breadth of a class definition that can be certified under *Wal-Mart*.

B. CLASS DISCOVERY WILL NEED TO BE MORE COMPREHENSIVE POST-*WAL-MART*

Plaintiffs almost certainly will need to develop a more substantial record than they generally have done in past class actions in light of *Wal-Mart*. Because “Rule 23 does not set forth a mere pleading standard[,] a party seeking class certification must affirmatively demonstrate his compliance with the Rule — that is, he must be prepared to prove that there are *in fact* sufficiently numerous parties, common questions of law or fact, *etc.*”¹⁶ Quite clearly, in order to prove compliance with Rule 23 based on actual facts, plaintiffs must develop a solid, thorough record through discovery. Bifurcating discovery between class and merits might still make sense in certain situations, but plaintiffs now must pursue broader and deeper discovery during the class certification phase of a case than was necessary pre-*Wal-Mart*. Accordingly, the line between class and merits

13 *Schleicher v. Wendt*, 618 F.3d 679, 681 (7th Cir. 2010) (“When a large, public company makes statements that are said to be false, securities-fraud litigation regularly proceeds as a class action.”); *In re Dynex Capital Inc. Secs. Litig.*, No. 05 Civ. 1897 (HB), 2011 WL 781215, at *2 (S.D.N.Y. Mar. 7, 2011) (plaintiffs satisfied commonality because the putative class members were impacted by the same misrepresentations and omissions); *Foganazzo v. Lehman Bros. Inc.*, 232 F.R.D. 176, 180 (S.D.N.Y. 2005) (“The commonality requirement has been applied permissively in securities fraud litigation. In general, where putative class members have been injured by similar material misrepresentations and omissions, the commonality requirement is satisfied.”).

14 *Benavides v. Chicago Title Ins. Co.*, 636 F.3d 699, 702 (5th Cir. 2011) (affirming denial of class certification, because “there was still no common question capable of class-wide determination.”); *Vega v. T-Mobile USA, Inc.*, 564 F.3d 1256, 1273 (11th Cir. 2009) (reversing class certification of purported breach of contract claim on several grounds, including that plaintiff failed to satisfy commonality requirement because he did not allege a common contract under which defendant employed all putative class members).

15 *Wal-Mart*, 131 S. Ct. at 2554-55.

16 *Id.* at 2551.

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discovery might become less meaningful than it was, because plaintiffs will need to obtain discovery that could very well relate to class and merits issues.

C. “SIGNIFICANT PROOF” REQUIRED

Plaintiffs must satisfy an evidentiary burden that requires “significant proof” of a common contention that is answerable on a classwide basis. While the quantum and nature of the requisite evidence will be litigated in district courts throughout the country, the Supreme Court has made it very clear that plaintiffs must present substantial proof to satisfy the commonality requirement of Rule 23(a)(2).

1. EXPERT TESTIMONY

Any expert testimony most likely will need to withstand a *Daubert* hearing.¹⁷ Moreover, even if expert testimony is admissible under *Daubert*, the expert’s conclusions must support the common contention that plaintiffs advance as the basis for a class action.¹⁸

2. STATISTICAL EVIDENCE

Class action plaintiffs frequently rely on statistical evidence to demonstrate that a self-selected sample provides a basis to extrapolate to the entire putative class. However, the Supreme Court in *Wal-Mart* determined that regional and national data did not by itself establish disparities at individual stores or a company-wide policy of discrimination.¹⁹ This finding provides defendants with a strong basis to challenge statistical evidence, though plaintiffs are not foreclosed from using such evidence going forward. The foreseeable battles over statistical evidence will focus on whether it would satisfy Rule 23(a)(2) commonality, either by itself or in conjunction with other evidence.

3. ANECDOTAL EVIDENCE

Plaintiffs and defendants frequently submit anecdotal evidence in the form of affidavits. This type of evidence can effectively buttress or oppose a motion for class certification. Assuming that affiants have personal knowledge and relevant experience, they can present first-hand accounts of a company policy or practice that is the subject of the litigation. In *Wal-Mart*, the plaintiffs submitted “120 affidavits reporting experiences of discrimination — about 1 for every 12,500 class members — relating to only some 235 out of Wal-Mart’s 3,400 stores.”²⁰ The Supreme Court found this evidence “too weak” and inadequate to support “any inference that all individual, discretionary personnel decisions are discriminatory.”²¹ The *Wal-Mart* Court contrasted this insufficient evidence with *Int’l Bhd. of Teamsters v. United States*, 431 U.S. 324 (1977), in which the plaintiff produced significant evidence. In *Teamsters*, the plaintiff (U.S. Government) submitted anecdotal evidence that represented one account for every eight

¹⁷ *Id.* at 2553-54 (noted in dicta that “[t]he district court concluded that *Daubert* did not apply to expert testimony at the certification stage of class-action proceedings. We doubt that is so . . .”); see *Am. Honda Motor Corp. v. Allen*, 600 F.3d 813, 815-16 (7th Cir. 2010) (holding full *Daubert* hearing was required prior to ruling on class certification); *In re Zurn Pex Plumbing Products Liab. Litig.*, 2011 WL 2623342, No. 10-2267, at *4 (8th Cir. July 6, 2011) (affirming “tailored” *Daubert* hearing at class certification phase).

¹⁸ *Wal-Mart*, 131 S. Ct. at 2554.

¹⁹ *Id.* at 2555.

²⁰ *Id.* at 2556.

²¹ *Id.*

members of the class.²² While there are no hard and fast rules regarding a precise number or ratio that qualifies as sufficient anecdotal evidence, *Wal-Mart* and *Teamsters* at least provide some guideposts concerning what has been determined to be adequate and inadequate. Needless to say, plaintiffs will definitely need to present a substantial quantum of anecdotal evidence for it to be credited as supporting classwide proof.

D. THE NEED FOR MINI-TRIALS?

In light of the heightened evidentiary burden plaintiffs must satisfy, federal courts might decide to conduct mini-trials regarding class certification on a more regular basis than in the past. Plaintiffs now must present “significant” evidence to support class certification. Defendants undoubtedly will contest plaintiffs’ evidence at every turn. While courts might be able to decide such disputes without a mini-trial in some cases, it is not difficult to see that there will be a more frequent need for mini-trials, particularly in cases involving expert testimony. Because developing class action law appears to require a *Daubert* hearing regarding expert testimony, it would provide a ready-made opportunity to expand that hearing to a mini-trial to cover any and all evidentiary issues that require resolution in connection with deciding class certification. And, even in cases without expert testimony, there still could be many disputed evidentiary issues that could require a mini-trial.

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²² 431 U.S. 324, 337-38 (1977).

A YEAR IN THE LIFE OF THE UK BRIBERY ACT

BY STEVEN PITT AND BARNEY CONNELL

I. INTRODUCTION

In last year's edition of this *Report*, we reported on the reform of the UK anti-bribery regime brought about by the Bribery Act 2010 (the "Act") and its potential consequences for the insurance industry. The Act entered into force on July 1, 2011 and this article reports on some significant developments since last year's edition, including the first six months of the Act "going live".

As last year's edition was going to press, the Ministry of Justice published its finalised guidance on what it considered to be reasonable procedures to prevent bribery by associated persons (the "MoJ Guidance").¹ On the same day guidance on the approach of prosecuting authorities to the Act's provisions was also published by the Director of the Serious Fraud Office ("SFO") and the Director of Public Prosecutions (the "Joint Prosecution Guidance").² More recently the Financial Services Authority ("FSA") published for consultation a guide on financial crime which contains a section devoted to bribery and corruption.

There has also been the first ever conviction for an offence under the Act, although that conviction did not concern the somewhat controversial "corporate offence" of failing to prevent bribery by an associated person.

Elsewhere, a £6.895 million fine imposed on Willis by the FSA for failings in its anti-bribery and corruption systems and controls (importantly, there was no finding that any bribery had occurred and the fine was not imposed under the Act) provides some indication as to how prosecuting authorities might assess a company's anti-bribery procedures when corporate prosecutions are eventually brought under the Act.

Meanwhile, while the SFO is yet to make its mark with a headline-grabbing prosecution, it has at least secured its future for the time being and has been promoting the use of deferred prosecution agreements as an important mechanism by which it may choose to enforce the Act.

II. RECAP OF THE ACT

In common with the U.S. Foreign Corrupt Practices Act ("FCPA"), the Act prohibits bribery of foreign public officials. However, unlike the FCPA, the Act also contains general bribery offences applicable to commercial settings which, in general terms, prohibit giving or receiving bribes in return for the improper performance of a relevant activity.

A further departure from the FCPA, and indeed from UK anti-bribery law prior to the Act's entry into force, is the offence of failure of a commercial organisation to prevent bribery. It is this new offence, sometimes referred to as the "corporate

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¹ "The Bribery Act 2010: Guidance about procedures which relevant commercial organisations can put into place to prevent persons associated with them from bribing (section 9 of the Bribery Act 2010)", The Ministry of Justice, March 2011.

² "Bribery Act 2010: Joint Prosecution Guidance of the Director of the Serious Fraud Office and the Director of Public Prosecutions", March 2011.

In terms of territorial application, the general bribery offences and the offence of bribing a foreign public official catch any act or omission carried out in the UK. They are also relevant to acts or omissions carried out anywhere in the world by a person with a close connection to the UK, e.g. a British national, an individual ordinarily resident in the UK or a company incorporated in the UK.

offence”, which attracted, and continues to attract, a great deal of attention from companies and legal practitioners. The offence imposes strict liability on companies for failing to prevent bribery by “associated persons” who could be employees, agents, subsidiaries, even joint venture partners, or any other person that performs services for or on behalf of the company. The only defence is for a company to have had in place “adequate procedures” designed to prevent associated persons from engaging in bribery. It is for this reason that the MoJ Guidance (discussed in more detail below), which the Government was required by the Act to publish in order to provide guidance on the procedures commercial organisations need to put in place, attracted so much attention.

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III. OFFICIAL GUIDANCE

A. THE MOJ GUIDANCE

The MoJ Guidance sets out six principles in light of which companies which fall within the scope of the Act should assess their anti-bribery procedures. In summary, these principles recommend that: (1) procedures should be proportionate to the “nature, scale and complexity” of a company’s activities; (2) top-level management should be committed to preventing bribery and promoting a culture in which it is never accepted; (3) a company should periodically assess the bribery-related risks it faces; (4) a company should perform proportionate due diligence into those who will perform services for it or on its behalf; (5) anti-bribery policies should be effectively communicated, including via training; and (6) anti-bribery policies and their implementation should be subject to monitoring and review. The MoJ Guidance also contains some general guidance on the Act and a selection of case studies in order to demonstrate how the six principles might be applied in practice.

B. THE JOINT PROSECUTION GUIDANCE

No prosecution can be brought under the Act without the consent of the Director of the SFO or the Director of Public Prosecutions (or, if applicable, the Director of Revenue and Customs Prosecutions) and the Joint Prosecution Guidance seeks to explain how the discretion to prosecute is likely to be exercised. It sets out the public interest considerations that will be taken into account in deciding whether to prosecute each of the offences under the Act and lists factors for, and against, prosecution in relation to a number of specific issues, including facilitation payments, hospitality and the new “corporate offence”.

C. THE FSA'S "FINANCIAL CRIME: A GUIDE FOR FIRMS"

In June 2011 the FSA published for consultation its *"Financial Crime: a guide for firms"* (the "FSA Guide").³ Rather than setting out mandatory requirements, the FSA Guide provides non-binding guidance on how firms can reduce the risk they face in relation to financial crime. However, the FSA has stated that it expects all FSA-regulated firms to be aware of its contents and to have given due consideration as to how to implement the guidance. The FSA also expects firms already to have in place systems and controls to adequately address bribery risks (as is demonstrated by the fine imposed on Willis which is discussed later).

The version of the FSA Guide published for consultation contains a chapter which specifically covers bribery and corruption. The content of that chapter is drawn from an FSA report published in May 2010 in relation to commercial insurance broking which was examined in last year's *Report*.⁴ The chapter sets out questions that firms need to ask themselves to assess, from an anti-bribery perspective, the adequacy of their governance mechanisms, risk assessments, policies and procedures, dealings with third parties and how they recruit, vet and train staff. It also provides examples of good and bad practices in respect of each area.

The fact that the guidance on bribery contained within the FSA Guide is based substantially on a much earlier report specific, at the time, to the commercial insurance broking sector, means that it is not entirely new. However, it is significant that the FSA's particular concern about how firms address relationships with third parties has been carried over from that specific report to guidance which is generally applicable. While it should be remembered that the FSA Guide is still at the consultation stage, it is reasonable to assume that as it concerns avoidance and prevention of bribery and corruption the final form of the FSA Guide will take a broad principles-based approach, avoiding a narrow closed-list approach. This would be in line with previous guidance sources which have stressed the need for companies to develop strategies specific to their businesses and industry sectors and that adopting a tick-the-box response to the Act will generally not be viewed particularly favourably.

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IV. ENFORCEMENT UPDATE

A. FIRST PROSECUTION UNDER THE ACT

August 2011 saw the first prosecution under the Act when a court clerk was charged with allegedly having accepted £500 from an individual summoned to court to face a motoring offence in exchange for influencing the course of the proceedings. The accused, Mr. Munir Patel, was later convicted of requesting and receiving a bribe intending to improperly perform his functions (one of the general bribery offences under Section 2 of the Act). In November 2011, he was sentenced to three years imprisonment for bribery which will be served concurrently with a six year sentence for misconduct in public office.

³ *"Consultation Paper CP11 / Financial Crime: A guide for firms"*, The Financial Services Authority, June 2011. The consultation closed in September 2011.

⁴ *"Anti-bribery and corruption in commercial insurance broking: Reducing the risk of illicit payments or inducements to third parties"*, Financial Services Authority, 14 May 2010.

While this is not the kind of high-profile corporate scalp that the SFO might have liked as a first prosecution to back up its tough tone on enforcement of the Act — indeed, it was actually brought by the Crown Prosecution Service (“CPS”) rather than the SFO — it does serve to illustrate two important points regarding the application of the general bribery offences under the Act.

First, while companies are right to be concerned at the prospect of their employees, agents and other associated persons giving bribes, this case serves as a reminder that the Act also prohibits requesting, agreeing to receive, or accepting bribes. In assessing the bribery-related risks they face, companies should not only consider which associated persons might be most likely to become involved in paying bribes (perhaps as a result of the overseas markets in which they work) but also any areas of their business where associated persons might be offered bribes (for example, where a broker or third party is looking to secure unduly favourable terms of business or an overly generous remuneration structure and engages in bribery to secure a contract which an honest person would not have entered into).

Second, although Mr. Patel happened to be a public official, that was not crucial to his prosecution under the Act. In fact his case had to be prosecuted under one of the Act’s general offences because he was not a *foreign* public official and, secondly, the specific offence relating to foreign public officials only prohibits offering, promising or giving a bribe to such an official, i.e. it does not prohibit officials from accepting bribes.⁵ The only bearing that Mr. Patel’s role as a public official may have had on his conviction for bribery is that it would have been abundantly clear that his conduct in return for the bribe amounted to “improper performance”, which occurs where a person breaches a relevant duty such as a duty to act in good faith. It remains to be seen how the courts might approach the concept of improper performance in the context of commercial dealings.

While it is disappointing (from the perspective of gaining greater insight into the methodology and priorities of the prosecuting authorities), it is perhaps unsurprising that we have yet to see a major prosecution by the SFO in respect of the new “corporate offence.”

The crucial point however is that the lack of any high profile corporate prosecutions to date should not be a source of comfort for companies which are yet to review their anti-bribery procedures in light of the Act.

While it is disappointing (from the perspective of gaining greater insight into the methodology and priorities of the prosecuting authorities), it is perhaps unsurprising that we have yet to see a major prosecution by the SFO in respect of the new “corporate offence”. This case was relatively easy to bring and the CPS was presumably assisted by the fact that Mr. Patel admitted to an undercover journalist that he took bribes and was filmed accepting cash. A prosecution for failing to prevent bribery will require the SFO to uncover conduct which occurred since July 1, 2011 (the Act’s provisions are not retrospective). Very little time has actually elapsed since the Act came into force. In addition, it is possible that persons engaged in corrupt practices have reacted to the Act coming into force with increased efforts at concealment. Even once a potential breach is identified, significant time will be consumed investigating and reviewing evidence before even getting to the stage of assessing whether the commercial organisation under investigation had procedures in place that would enable it to make use of the defence. In addition, the “corporate offence” is an entirely new offence in UK law meaning that none of the prosecuting authorities have experience of it and they are unable to draw on any precedent to assist with issues of legal interpretation. The crucial point however is that the lack of any high profile corporate prosecutions to date should not be a source of comfort for companies which are yet to review their

⁵ That is not to say that a UK public official could not be prosecuted for accepting (or giving) a bribe in his or her official capacity. Mr. Patel was also charged with misconduct in public office on the basis that he had been giving advice to people about how to avoid being summoned to court for traffic offences.

anti-bribery procedures in light of the Act.

B. WILLIS FINED BY THE FSA

In July 2011, the FSA imposed a fine of £6.895 million on Willis Limited, a UK incorporated company within the Willis group, for various failings in its anti-bribery and corruption systems and controls.⁶ The fine would have been almost £10 million were it not for a 30 per cent reduction which Willis received on account of it agreeing to settle with the FSA at an early stage in its investigation. It should be emphasised that no prosecution was made under the Act, that the FSA did not seek to determine that any of Willis's business was corrupt and that Willis promptly took steps to strengthen its procedures.⁷ The fine was imposed as a result of inadequacies in Willis's systems and controls aimed at addressing the risk of bribery and corruption in connection with payments to overseas third parties which assisted in obtaining business for Willis, particularly in jurisdictions where the risk of bribery and corruption is high. It related to a period prior to the entry into force of the Act and, in any event, the Act is only engaged where bribery actually occurred and a company's procedures failed to prevent it.

Nevertheless, this case should be of significant interest to companies in the insurance and reinsurance industries. First, it highlights the risk taken by any FSA-regulated company which does not have adequate procedures in place, regardless of whether its associated persons are found to have engaged in bribery. In its Final Notice to Willis, the FSA stated that it considered the failings to be serious in part because “[t]he involvement of UK financial institutions in corrupt or potentially corrupt practices overseas undermines the integrity of the UK financial services sector.”⁸ The FSA also noted that corrupt practices endanger two of its statutory objectives of maintaining confidence in the UK financial system and reducing financial crime.⁹ This appears to indicate that the FSA will continue to take a firm stance in relation to bribery and corruption in order to safeguard the reputation of the UK as a financial centre where business is conducted ethically.

Further, the details of the case provide a specific example in the context of the insurance industry of the kinds of practices which present a high level of bribery risk and which will, therefore, attract a high level of scrutiny from regulators and, potentially, prosecutors. As stated above, the risk which Willis's procedures failed to address adequately was the risk associated with payments to third parties who assisted in winning business overseas, particularly in high risk jurisdictions. Willis's procedures were criticised for failing to require that an adequate business case was made for why such payments were necessary as opposed to a direct approach by Willis to the target entity. The FSA did not object to the use of overseas third parties to assist in winning business *per se* but concluded that, in the circumstances, there was “an unacceptable risk that payments made by Willis Limited to Overseas Third Parties could be used for corrupt purposes, including paying bribes to persons connected with the insured, the insurer or public officials.”¹⁰ At the beginning of the period covered by the fine, Willis's personnel were providing descriptions of the reasons for making

⁶ See the FSA's Final Notice to Willis Limited dated 21 July 2011.

⁷ Indeed, the FSA recognised as a mitigating factor that Willis took a series of steps to address the risk of bribery and corruption, including enhancement of its systems and controls.

⁸ Final Notice at paragraph 2.6 (1).

⁹ The FSA's statutory objectives are set out in Sections 3 to 6 of the Financial Services and Markets Act 2000.

¹⁰ Final Notice at paragraph 2.3.

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The FSA's assessment therefore provides a useful indication of how authorities responsible for enforcing the Act might in future determine whether a company's procedures are sufficient to engage the defence available under the Act.

The FSA stated that the review focused on whether procedural requirements had been complied with, such as the authorisations which were obtained, rather than considering substantive issues, including the commercial rationale for payments and the sufficiency of the due diligence which was carried out.

such payments. However, the FSA found that personnel did not receive formal training, and did not record in adequate detail the reasons for sharing commissions with third parties.

A number of parallels can be drawn between the principles set out in the MoJ Guidance and the FSA's assessment of the failings in Willis's procedures during the period covered by the fine. The FSA's assessment therefore provides a useful indication of how authorities responsible for enforcing the Act might in future determine whether a company's procedures are sufficient to engage the defence available under the Act.

By way of example, due diligence is one of the key principles set out in the MoJ Guidance. In relation to Willis, the FSA made observations on the due diligence conducted in relation to third parties, noting that in some instances due diligence was conducted only once a payment was scheduled to be made and Willis was already obliged to make it, rather than when the payee was first engaged. The FSA's assessment also illustrates that it is essential to consider not only the form of procedures in place but also whether they are properly implemented and whether that implementation is sufficient to achieve its substantive purpose. The FSA noted that after Willis introduced further guidance on how to approach payments to overseas third parties, some personnel continued to take the same approach as they had taken before. It also commented on a review conducted by Willis (again, part way through the period covered by the fine) of a sample of its relationships with overseas third parties. The FSA stated that the review focused on whether procedural requirements had been complied with, such as the authorisations which were obtained, rather than considering substantive issues, including the commercial rationale for payments and the sufficiency of the due diligence which was carried out.

V. THE FUTURE OF THE SFO

In the Spring of 2011, the SFO's attempts to communicate its intention to actively enforce the Act against companies risked being undermined by rumours that the SFO's days were numbered. There had been speculation concerning the SFO's future since the election of the current coalition Government in May 2010. The coalition's programme for government included a plan to rationalise the white collar crime elements of the SFO, FSA and Office of Fair Trading ("OFT"),¹¹ which would have led to the creation of a new Economic Crime Agency.

The FSA and OFT, in particular, opposed this initial plan which was eventually shelved. Subsequently, in April and May of 2011, it was reported that there was a debate within Government as to whether the SFO's prosecution and investigation functions should be split between the CPS and a new National Crime Agency ("NCA") respectively, the latter being compared in the press to the U.S. Federal Bureau of Investigation.

¹¹ "The Coalition: our programme for government", HM Government, May 2010, page 9.

In June 2011, the Home Secretary quashed these rumours by announcing that the SFO would remain in its current form. Instead of having its investigatory function subsumed within the NCA, it will continue as a specialist agency working with the NCA's Economic Crime Command. However, it is probable that speculation as to the SFO's future will not be eliminated entirely until the Government's new framework of authorities has been established and it has been demonstrated that the SFO can work effectively under the overview of the NCA. It is expected that the NCA will become fully operational in 2013.

VI. DEFERRED PROSECUTION AGREEMENTS

While the SFO will remain intact for the time being, the means by which it can enforce the Act are likely to continue to evolve. For some time, the SFO has encouraged companies to self-report instances of bribery and corruption. It has also intimated that it would ideally like to take an approach similar to that of the US Department of Justice ("DOJ") whereby it would enter into agreements with offending companies requiring them to conduct investigations, put in place compliance programmes, submit to monitoring and pay a fine in return for having prosecution deferred. As we reported last year, however, the scope for the SFO to adopt a similar approach to the DOJ is currently limited because it lacks the power to enter into agreements regarding offenders' sentences.¹²

Notwithstanding this restriction, the SFO does retain flexibility as it can, in appropriate cases, pursue a civil recovery order enabling it to recover the proceeds of unlawful conduct rather than bring a criminal prosecution against the offenders. The SFO's guidance on self-reporting indicates that it will look to settle cases by the civil route "wherever possible" except where there is evidence that board members were personally involved in corrupt activities.¹³ Nonetheless, the fact remains that in cases where civil recovery is inappropriate in light of the gravity of the unlawful conduct, the SFO can only influence an offender's penalty to the extent that it has discretion over which offences to charge it with. If and when it finds an opportunity to charge a company with the "corporate offence" of failing to prevent bribery by an associated person, the penalty to be imposed will ultimately be decided by the court.

However, it appears that this situation could change to some extent (although the court's ultimate discretion as to sentencing is likely to remain). In September 2011, the Solicitor General (in England and Wales the deputy to the Attorney General) publicly indicated his support for the development of a regime for deferred prosecution agreements in the UK. At the time of writing he has embarked on a series of meetings together with the Director of the SFO (including one meeting which was hosted at Sidley Austin's London office on November 23, 2011) to discuss proposals for such a regime and it is expected that those meetings will be followed by a formal consultation process.

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¹² See *our* comments in last year's article where we referred to the criticism of an attempt by the SFO to enter into a plea bargain in *Regina v Imospec Ltd* [2010] EW Misc 7 (EWCC) (18 March 2010).

¹³ "The Serious Fraud Office's Approach to Dealing with Overseas Corruption"

VII. CONCLUSIONS AND PREDICTIONS FOR THE YEAR AHEAD

Although almost a year has passed since we last reported on the Act, the Act itself has only been in force for some seven months. Apart from one prosecution (which was for a relatively minor offence by an individual unconnected with a commercial enterprise) there has been no other public prosecutorial activity which has reached the court system in respect of offences under the Act. This is perhaps unsurprising given the short time since the Act has been in force and the inherent complexity of investigations into bribery and corruption within commercial organisations.

There is nothing to suggest that the prosecuting authorities have abandoned or eased off on their efforts to investigate potential offences and to make use of the Act's provisions.

There is nothing to suggest that the prosecuting authorities have abandoned or eased off on their efforts to investigate potential offences and to make use of the Act's provisions. This is also the case even with the SFO which has seen extensive debate over its continuing role and future structure. Official support to regularise the use of deferred prosecution agreements could result in a rapid increase in the frequency of self-reporting. The fine levied on Willis by the FSA generated extensive market interest not only for the specific allegations made and level of penalty but, perhaps more significantly, for the insight the FSA's report gave into possible future deliberations concerning alleged offences under the Act. The limited amount of further guidance which has been issued has not provided industry with officially approved internal procedures and risk management strategies. This is in line with the oft repeated concern that a tick-the-box, one-size-fits-all approach to bribery and corruption issues is inappropriate and must be avoided.

As for the coming year, it is to be expected that further prosecutions under the Act will be brought. While some, or indeed the majority, may be of the more straightforward variety, given the continuing political emphasis on preventing bribery and corruption, it is only a matter of time before the prosecuting authorities get their headline-grabbing case.

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