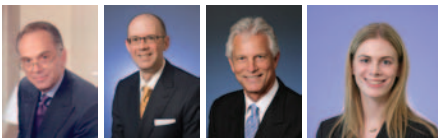


Commercial Insurance

Directors & Officers Liability Insurance

Securities & Exchange Commission Claims

Multiple Representations: The SEC v. D&O Insurers



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In January 2010, the Securities and Exchange Commission (SEC) announced a series of measures designed to encourage individuals and companies to cooperate earlier and more fully in the agency's investigations and enforcement actions.¹ The new initiative formalizes cooperation incentives to help investigators

develop first-hand evidence. These new measures are set forth in a new section of the SEC's Enforcement Manual, entitled "Fostering Cooperation."²

The SEC's "sequestration" rule, the cooperation incentives, and recent comments by senior SEC staff demonstrate an antipathy for having multiple witnesses or targets of an investigation or enforcement action represented by a single lawyer or firm. For years it has been SEC policy—though seldom invoked—to discourage multiple-representation through its "sequestration" rule. While there is nothing in the Enforcement Manual that expressly requires, or encourages, individuals to engage separate counsel (to the contrary, it recognizes the common practice of multiple-representations),³ the cooperation incentives will likely pit potential witnesses or targets of an SEC inquiry against one another, ultimately requiring that they engage separate counsel to protect their interests. The Director of the Division of Enforcement intimated as much in a recent speech in which he decried "questionable defense practices" that include representations of multiple individuals and corporations with seemingly "adverse interests."⁴

This pressure by the SEC to ensure separate counsel for witnesses for, or targets of, its investigations creates obvious problems for directors and officers liability (D&O) carriers and insureds. Will existing D&O policies permit separate counsel for those who request it? If not, how can insureds provide their directors and officers with comprehensive protection? Is this possible at a reasonable cost?

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SEC's Cooperation Initiatives

To improve the quality, quantity, and timeliness of information and assistance it receives, the SEC has approved various tools (previously only available to the Department of Justice) to encourage individuals and companies to report violations and provide assistance to the Commission. These tools include:

- (1) proffer agreements;
- (2) cooperation agreements;
- (3) deferred prosecution agreements; and
- (4) non-prosecution agreements.⁵

In establishing how the Commission will determine which, if any, of these tools to use to encourage an individual's cooperation, the Commission's staff (the Staff) will assess, among other things, the value of the assistance the individual is likely to provide.⁶ Among the factors the Staff will consider in determining the value of an individual's cooperation is "[t]he timeliness of the individual's cooperation, including whether the individual was first to report," and "[w]hether the Investigation was initiated based on information provided by the individual."⁷

The fact that cooperation incentives may be granted to individuals who report early in, or before, the SEC's investigation may ultimately result in a "race to the Commission" that is likely to pit potential corporate witnesses or targets against one another. Counsel with multiple corporate clients will likely be placed in the untenable position of determining which of their clients will be first to cooperate and which may be "thrown under the bus." To be sure, this potential dilemma may prevent counsel from accepting multiple-representations in the first instance.

SEC's Sequestration Rule

For many years the SEC, pursuant to Rule 7(b) of its Rules Relating to Investigations, has reflected its preference that witnesses or targets of its investigations be represented by separate counsel.⁸ Though anyone who appears in person at a formal investigative proceeding is entitled to be accompanied by counsel, the so-called "sequestration" rule provides that the witness "shall be sequestered, and unless permitted in the discretion of the officer conducting the investigation no witness or the counsel accompanying such witness shall be permitted to be present during the examination" of the witness.⁹ The SEC has attempted, on a number of occasions, to enforce this sequestration rule, but has been largely unsuccessful in its attempts.¹⁰

The courts have attempted to balance the SEC's desire to reduce the likelihood that witnesses with common counsel will tailor their testimony to that given by earlier testifying witnesses against the individual's right to counsel of his or her own choice. In *SEC v. Csapo*, the court noted that Section 6(a) of the Administrative Procedure Act (APA),¹¹ which provides that any person summoned to appear before a federal agency is entitled to the assistance of

counsel, controlled the interpretation of the SEC's sequestration rule.¹² The court also noted that the right to counsel conferred by the APA has been construed as the right to counsel of one's choice.¹³ In order to overcome the individual's overriding right to counsel, the *Csapo* court found that the SEC must present "concrete evidence" that the multiple-representation would "obstruct and impede its investigation."¹⁴

Multiple Representations

The Enforcement Manual acknowledges that "[i]t is not unusual for counsel to represent more than one party" in an investigation.¹⁵ Furthermore, representing more than one party, such as employees of the same company, "does not necessarily present a conflict of interest, although it may heighten the potential for a conflict of interest."¹⁶ The Manual also provides that when an attorney represents multiple parties, Staff in testimony usually informs the party of what is contained in the SEC's Form 1662, which states that "the Commission will assume that you and counsel have discussed and resolved all issues concerning possible conflicts of interest."¹⁷

However, beginning in January 2010, when the SEC announced a series of cooperation measures encouraging greater cooperation from individuals and companies in the agency's investigations and enforcement actions, it has become difficult to predict when the SEC will view multiple representations as an impediment to the SEC's new cooperation tools. The new cooperation tools laid out by the SEC and the rewards they provide to helpful and early cooperators such as reduced sanctions, or even no sanctions, in exchange for timely, truthful, and substantial assistance in an SEC investigation, are clearly going to heighten the potential for conflict of interest in multiple representations.

SEC Staff Public Statements on Multiple-Representation

On June 1, 2011, Robert S. Khuzami, Director of the SEC's Division of Enforcement, specifically cautioned the white collar bar in an address to the Criminal Law Group of the UJA-Federation of New York that, while multiple representations remain fairly common, "[t]here are numerous examples of defense counsel representing multiple individuals with seemingly divergent interests."¹⁸ Mr. Khuzami cited two examples of conflicts of interest in multiple representations: (1) an attorney representing both a supervisor and the person he supervised in a "failure to supervise" case; and (2) an attorney representing himself, the alleged wrongdoer, and the principal investor, who testified that he was not worried that he had invested almost his entire net worth with a person who had multiple felony convictions.¹⁹

Mr. Khuzami warned that, in light of the new cooperation program, there is a greater "likelihood that one counsel cannot serve the interests of multiple clients, given the real benefits that could result from cooperation, such as one client testifying against another client represented by the same counsel."²⁰ Moreover,

Mr. Khuzami said that given the potential for cooperation, the SEC is taking a closer look at “seemingly adverse” multiple representations and cautioned the white collar bar that they will “likely see an increase in concerns expressed by SEC staff in those situations.”²¹

SEC Action to Prevent Multiple-Representation

The same day that Mr. Khuzami cautioned the white collar bar that it would be scrutinizing multiple representations, the SEC moved to disqualify certain defense attorneys in an administrative proceeding against Morgan Asset Management, Inc., Morgan Keegan & Co., Inc., and two employees who were accused of fraudulently overstating the value of securities in funds backed by subprime mortgages. A single law firm was representing all four respondents and previously had represented additional witnesses during the SEC’s investigation.²²

The SEC alleged two conflicts in support of its motion to disqualify. First, the four respondents had “potential defenses involving the same conduct of [each] other, but they are foreclosed from any such blame-shifting.”²³ The second alleged conflict arose from the fact that the firm represented not only the four respondents, but additional witnesses whom the SEC expected to call as witnesses during the hearing.²⁴

Respondents opposed the SEC’s motion by arguing, among other things, that the SEC should not be permitted to interfere with their statutory right to the attorneys of their choice or to force its own ideas of a proper defense on them via a disqualification motion.²⁵

The Administrative Law Judge (ALJ) denied the motion to disqualify respondents’ attorneys. He concluded that the SEC had failed to show “an actual conflict of interest,” but rather only a potential conflict of interest that is insufficient to justify disqualification of the firm.²⁶

The ALJ’s order in *Morgan Asset Management* made clear that motions to disqualify counsel are “strongly disfavored” as they frequently “pose the very threat to the integrity of the judicial process that they purport to prevent.”²⁷ At a minimum, the SEC carries the burden of showing that counsel has a “concurrent conflict of interest” within the meaning of Model Rule 1.7(a)²⁸ which provides that a conflict of interest exists if (1) the representation of multiple clients will be “directly adverse” to one of the clients, or (2) there is a significant risk that the representation of a client will be “materially limited” by the representation of other clients. And, even if a concurrent conflict of interest under Model Rule 1.7(a) exists, a lawyer may still represent a client if the following four conditions are satisfied: (1) the lawyer reasonably believes he or she will be able to provide competent and diligent representation to each affected client; (2) the representation is not prohibited by law; (3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and (4) each affected client provides informed consent, confirmed in writing.²⁹

The Effects of the SEC’s Preference for Separate Counsel on D&O Coverage

In most situations, a corporation will pay or reimburse legal expenses of directors and officers brought into an SEC investigation involving the corporation even if indemnification is not strictly required. However, an individual director or officer and the corporation might not see eye to eye on whether the individual should have common representation with other directors, officers or the corporation. Alternatively, an individual director or officer and the corporation might have parted ways with the corporation refusing to provide indemnification. In these situations, as well as instances where the corporation is bankrupt, the D&O policy proceeds would be the only source of reimbursement. Of course, one consequence of having separate counsel is that retentions and limits will erode more quickly.

While the SEC’s cooperation incentives may result in greater use of separate counsel for the directors and officers of a corporation that is the subject of an investigation or enforcement action, it is possible that the resulting additional expense will not be covered under a standard D&O liability policy. There are two reasons for this. First, the extra expense might be incurred before there is a claim that triggers coverage. Second, even if coverage has been triggered, the D&O insurer might not agree that separate counsel is a necessary and reasonable expense solely because of the potential for reduced penalties from cooperation.

Most D&O policies only cover legal expenses if they are incurred in the investigation, negotiation, settlement, and defense of a “claim” against an insured director or officer. “Claim” may be defined to include administrative or regulatory investigations and enforcement actions, but usually there must be at least a written demand or notice identifying the insured director or officer as a target of the investigation or action. Many policies provide coverage for securities claims against the corporation and related defense costs, but usually coverage for administrative or regulatory proceedings is provided only if there is also a claim against an insured director or officer.

How these common terms apply to an SEC investigation was recently considered by the U.S. Court of Appeals for the Eleventh Circuit. In *Office Depot, Inc. v. National Union Fire Insurance Co.*,³⁰ the Eleventh Circuit held that coverage was not available for legal expense incurred after the SEC sent Office Depot a letter advising it that the SEC would begin conducting an inquiry into whether it violated the securities laws and requested production of certain documents, but before a *Wells* notice informing the insured officers of its recommendation to commence an action against them was sent. The court determined that the SEC’s requests for voluntary cooperation in furtherance of its pre-suit discovery constituted an “investigation,” rather than an “administrative or regulatory proceeding,” and concluded that the expenses were not covered by National Union’s policy because they did not identify specific individuals that could be charged in future proceedings as required by the policy.³¹

Most D&O policies only provide reimbursement for defense costs that are necessary and reasonable. Insurers often rely on this

limitation on defense costs to withhold reimbursement for the legal fees of separate defense lawyers if the insurers believe the legal work is duplicative. Insurers will allow fees for separate counsel if the separate counsel can be justified by the existence of divergent interests among separate defendants. In those circumstances, the insurers may consider the added expense of separate counsel to be necessary and reasonable.

The question that insured corporations and insurers now face is whether the SEC's incentives for cooperation make separate counsel a necessary and reasonable expense. The difficulty is that the facts will not be well enough developed at the time separate counsel needs to be engaged to determine whether the interests are aligned or divergent during the investigation phase. As is often the case with coverage issues, building an evidentiary record to demonstrate divergent interests potentially compromises the defenses.

Coverage Alternatives

At least one insurer is offering coverage for “pre-claim inquiry costs,” defined as reasonable and necessary fees, costs, and expenses incurred in preparation of an insured director or officer in connection with a response to a “pre-claim” inquiry directed to that person.³² Some insurers may, on an individual basis, agree to modify the definition of “claim” in the standard D&O policy to include legal expense incurred by or on behalf of an individual director or officer (but not the insured organization) in responding to an investigation, whether or not the individual has been specifically identified as the target of the investigation. Insurers may charge additional premium for this coverage. Whether the coverage is purchased in the form of a modification to the definition of “claim” versus a stand-alone “pre-claim” coverage may have an impact on retentions and limits.

Insureds that purchase Side A-only coverage or Difference-in-Conditions coverage may want to request this coverage to protect against where the corporation is bankrupt or refuses to provide indemnification. As to whether the expense of separate counsel will be covered as a necessary and reasonable expense, buyers can seek to address this by pressing for policy endorsements to clarify that legal expenses for separate counsel for SEC investigations is covered. The Enforcement Manual may create an opportunity for D&O insurers to differentiate their product offerings by endorsing their policies to provide assurances that coverage will be provided. Whether insurers can do this for a reasonable price remains to be seen.

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“Beyond Arbitration: Designing Alternatives to Securities Litigation”; “Stockbroker Supervision: Managing Stockbrokers and Surviving Sanctions”; “Redeeming Fallen Brokers: Managing the Aftermath of Broker-Dealer Enforcement Proceedings”; “Takeovers: Attack & Survival”; “Securities Practice: Federal and State Enforcement”.

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¹ See SEC Press Release No. PR-2010-6 (Jan. 13, 2010).

² See Securities and Exchange Commission, Division of Enforcement, Enforcement Manual, Section 6 (Aug. 2, 2011) (Enforcement Manual).

³ See Enforcement Manual, Section 4.1.1.1.

⁴ See Robert S. Khuzami, Director, SEC Division of Enforcement, Speech by SEC Staff: Remarks to Criminal Law Group of the UJA-Federation of New York (June 1, 2011) (Khuzami Speech).

⁵ See Enforcement Manual, Sections 6.2.1 – 6.2.4.

⁶ See Enforcement Manual, Section 6.1.1.

⁷ *Id.*

⁸ See 17 C.F.R. § 203.7(b).

⁹ *Id.*

¹⁰ See, e.g., *SEC v. Higashi*, 359 F.2d 550 (9th Cir. 1966); *SEC v. Csapo*, 533 F.2d 7 (D.C. Cir. 1976).

¹¹ See 5 U.S.C. § 555(a).

¹² *Csapo*, 533 F.2d at 10.

¹³ *Id.* at 11, citing *Backer v. Comm’r*, 275 F.2d 141 (5th Cir. 1960).

¹⁴ *Id.* at 11, citing *Great Lakes Screw Corp. v. NLRB*, 409 F.2d 375, 380-81 (7th Cir. 1969).

¹⁵ See Enforcement Manual, Section 4.1.1.1.

¹⁶ *Id.*

¹⁷ *Id.*; see also SEC Form 1662, § B.2.

¹⁸ See Khuzami Speech, *supra* note 4.

¹⁹ *Id.*

²⁰ *Id.*

²¹ *Id.*

²² See *In re Morgan Asset Mgmt., Inc., et al.*, SEC Release No. 657/File No. 3-13847, Order Denying Motion to Disqualify Attorneys (July 19, 2010).

²³ *Id.* at 1 (quoting Div. Mot. at 1.).

²⁴ *Id.*

²⁵ See *id.* at 2.

²⁶ See *id.* at 6.

²⁷ See *id.* at 3.

²⁸ *Id.* at 4; see also ABA Model Rules of Prof’l Conduct R. 1.7(a) (2010), available at http://www.americanbar.org/groups/professional_responsibility/publications/model_rules_of_professional_conduct/rule_1_7_conflict_of_interest_current_clients.html.

²⁹ See *id.* at 5; see also ABA Model Rules of Prof’l Conduct R. 1.7(b).

³⁰ *Office Depot, Inc. v. Natl. Union Fire Ins. Co. of Pittsburgh, PA*, No. 11-10814, 2011 BL 263691 (11th Cir. Oct. 13, 2011).

³¹ *Id.*

³² Chartist Executive Edge Broad Form Management Liability Insurance Policy (4/10 ed.).