

Loss of SEC “neither admit, nor deny” settlements could have significant impact

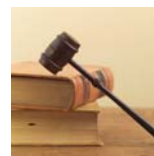
For forty years, the Securities & Exchange Commission (SEC) has allowed defendants to settle SEC matters and pay monetary penalties and disgorgement while “neither admitting, nor denying” the truth of the allegations against them. This practice allowed the SEC to avoid overt denials of wrongdoing, while also allowing defendants avoid creating admissions that could be used against them in separate civil proceedings—or by D&O insurance carriers seeking to prove underlying facts necessary to exclude coverage under certain conduct-based exclusions.

Recent challenges to this long-held practice have led the SEC to rescind this settlement option for defendants who have been separately convicted in parallel criminal proceedings or who have admitted to criminal conduct in Deferred Prosecution Agreements or Non-Prosecution Agreements with the Department of Justice (DOJ). At the same time, the SEC has appealed a decision by New York Federal Judge Jed Rakoff rejecting a proposed civil settlement between the SEC and Citigroup that did not require the company to admit any wrongdoing.

The settlement arose over allegations that Citigroup tried to “dump” toxic mortgage-backed securities on unsuspecting investors. The judge rejected the settlement due to its “neither admit, nor deny” language because it asked the Court to be a “mere handmaiden to a settlement privately negotiated on the basis of unknown facts, while the public is deprived of ever knowing the truth in a matter of obvious public importance.” The SEC’s surprising decision to appeal Judge Rakoff’s ruling rather than present him with a revised settlement proposal places the issue of the SEC’s practice of allowing “neither admit, nor deny” settlements in civil matters squarely before a federal appellate court.

With the SEC voluntarily changing its practice with regard to matters that are both civil and criminal as of this month and the issue before an appellate court on civil-only settlements, the future of this practice is uncertain. Importantly, this creates large ques-

tions about the future of SEC settlement negotiations and whether more constrained settlement rules will lead to fewer settlements and more trials with the SEC, as well as whether more trials and more admissions in SEC matters will make it easier for civil litigants to prove necessary facts for corporate and executive liability in follow-on civil litigation and give insurance carriers more fodder to deny coverage based on conduct exclusions.



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CIVIL SETTLEMENTS

After a long investigation, the SEC brought a civil enforcement action against Citigroup in federal court in October 2011. As is common, on the same day, the SEC also submitted a proposed consent judgment in the case that required Citigroup to pay \$285 million in civil penalties, disgorgement, and pre-judgment interest and enact certain remedial measures—all the while neither admitting, nor denying the SEC’s allegations against it. The matter was assigned to Judge Rakoff, who has a recent history of rejecting SEC settlements and challenging SEC settlement practices. He rejected the settlement because the SEC’s “neither admit, nor deny” language gave him no factual basis to know whether the settlement was “fair, reasonable, adequate, and in the public interest.”

In another highly-publicized tangle with the SEC, Judge Rakoff had previously rejected a

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The material in this document is not intended to provide legal advice as to any of the subjects discussed, but is presented for general informational purposes only. Readers should always consult knowledgeable counsel for any specific legal questions.

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FDIC sues insurer directly in failed bank action

The FDIC has long gone after D&O insurance proceeds in its actions against failed banks. That is usually done by bringing actions against the officers and directors. However, in a recent action involving a failed Puerto Rican bank, the FDIC sued the insurer directly, alleging that it is liable for the full limits of both a primary and excess policy it issued to the bank. While it seems odd from a procedural standpoint that the FDIC can proceed against the insurance carrier without first obtaining a judgment against the officers and directors, commentators suggest that action by the FDIC is being sought under a unique Puerto Rican statute that allows direct action against a wrongdoer's insurance carrier.

Continued: SEC settlement policy changes

2009 settlement between the SEC and Bank of America for similar reasons. In that case, the parties later went back to the judge with a settlement that he reluctantly approved. This time, however, the SEC chose to challenge Judge Rakoff's rejection of its proposed settlement.

The impact of the Second Circuit's decision in the appeal could be far-reaching. If the Second Circuit—where many of the SEC's cases are brought due to inclusion of Wall Street within its bounds—agrees with Judge Rakoff, the SEC's settlement practices may be fundamentally altered. As the SEC has lamented, requiring companies and their executives to admit wrongdoing could prevent many settlements, as companies are reluctant to create admissions that could be used against them in shareholder actions that could be equally or more devastating to company finances than a SEC matter. Similarly, such admissions would likely prevent executives from agreeing to settlements for fear of ending their careers or losing their personal assets. Such a fundamental change in settlement practices creates a catch-22 for companies and executives—refuse to admit wrongdoing, and a costly and risky trial with the SEC becomes likely; admit wrongdoing and pave the evidentiary path for shareholders to prove misconduct in civil litigation.

PARALLEL CRIMINAL MATTERS

The SEC's new policy on disallowing "neither admit, nor deny" settlements in civil matters in which there are parallel criminal matters would not affect cases like the Citigroup case or other matters that are civil in nature only. Because admissions are already required to settle almost all DOJ matters, the impact of requiring such admissions to settle parallel SEC matters will not be nearly as great as it would be in civil-only matters. The practical reality is that if a defendant has already settled the matter with criminal authorities, the admissions already exist in public record, and defendants are unlikely to resist subsequent admissions in a civil matter.

COVERAGE ISSUES

The impact on D&O insurance is easy to en-

vision. More trials with the SEC leads to litigation costs and poses a significant risk of loss for companies. Settlements with the SEC that admit wrongdoing will likely increase the number of follow-on civil suits by shareholders, but more importantly, such admissions could leave companies and their executives virtually unable to defend themselves in civil litigation, leading to larger settlements. Companies will turn to their D&O carrier for these losses. D&O carriers will look for ways to avoid or minimize these losses.

All D&O insurance policies contain conduct-based exclusions, which provide that if it is shown that certain conduct occurred, coverage for losses related to that conduct is excluded. For example, virtually all policies exclude coverage for fraud or intentionally violating the law. Thus, if admissions in SEC settlements prove that the company or certain executives committed fraud or intentional violations of the law, coverage could be lost. Carriers may attempt to use the conduct exclusions to both avoid indemnification for settlements in SEC and civil litigation matters, as well as to cut off defense costs.

In order to avoid loss of coverage, it will be very important to draft policies in a manner that tries to prevent or delay the application of conduct-based exclusions, such as delaying the trigger for conduct exclusions until the underlying matter is unappealable. To ensure coverage for individuals under a D&O policy, it will be imperative to ensure that the policy contains language to prevent the admission of one individual from being imputed to other individuals covered under the policy. Also, it may be important to consider the policy's language on rescission and any warranties made by the company when the policy is placed to avoid scenarios in which admissions by senior-level officials or the company lead to rescission of the policy altogether, thereby denying coverage to those innocent of wrongdoing.

Finally, companies may need to consider whether higher limits may be necessary to address the possibility of additional defense costs or greater settlements in follow-on civil litigation.

Labor Relations Board issues blow to mandatory arbitration agreements

The National Labor Relations Board (NLRB) ruled this month that a requirement by a real estate company that its employees sign arbitration agreements that required them to arbitrate all employment disputes, but precluded them from any form of collective or class employment actions violated labor laws.

The Board's ruling casts doubt on the arbitration agreements between thousands of employers and their employees around the country. The matter arose when a non-union superintendent filed a notice of intent to arbitrate of behalf of himself and a nationwide class of company superintendents, claiming that they were improperly classified as exempt employees and therefore unfairly denied overtime. The company rejected his notice of intent to arbitrate on the basis that the mandatory arbitration agreement he signed as a condition of his employment prevented the arbitration of class claims. The superintendent then filed a claim with the NLRB, arguing that the company's requirement that he waive his right to collective or class action violated federal labor laws. The NLRB agreed.

The Board held that an employee's right to pursue a dispute over employment practices through collective or class action was protected as a part of an employee's right to engage in "concerted activities for the purpose of collective bargaining or other mutual aid or protection" under Section 7 of the National Labor Relations Act (NLRA). The Board's ruling means that while a given action by an employee may not be protected by the NLRA, his ability to join with others in pursuing such actions may be. Experts see the

ruling as part of a larger NLRB effort to expand the meaning of "concerted activities."

The NLRB addressed the seeming conflict between its ruling and the U.S. Supreme Court's 2011 ruling in *AT&T Mobility v. Concepcion* that the Federal Arbitration Act (FAA) preempts state laws that bar class action waivers in arbitration agreements for public policy reasons. The Board argued that its decision did not conflict with the Court's holding because rather than address the preemption of state laws by federal law, it addressed the interaction between two federal laws—the FAA and the NLRA. The Board argued that the FAA does not require the waiver of the substantive right to concerted activity provided by the NLRA.

This ruling casts doubt on the wisdom of requiring employees to agree to class action waivers in arbitration agreements—a practice that, while common before, became more common following the Supreme Court's ruling in *AT&T Mobility v. Concepcion*. Even if courts decline to follow the NLRB's ruling in favor of the Court's decision, employers may still face collateral attacks by employees before the NLRB. And, if courts do follow the guidance of the NLRB, companies may find themselves embroiled in more employment class actions.

FOR MORE ON THE AT&T MOBILITY V. CONCEPCION CASE, SEE THE JUNE 2011 EDITION OF SAGACITY.

FMLA decision protects employee not eligible for leave

A recent federal appellate decision held that employees who make requests for Family Medical Leave Act (FMLA) leave but are not yet eligible to take leave are protected under the Act if the leave would occur after they are eligible.

An employee must work for an employer for one year before becoming eligible for leave under the FMLA. In the case before the Court, a woman had been working for her employer eight months when she informed them that she was pregnant and planned to take FMLA leave approximately two months after her one-year anniversary with the company. She was terminated three months later, just shy of her one-year anniversary.

The employee sued, alleging that her termination was both in retaliation for her request to take leave and interference with her right to do so. The Eleventh Circuit agreed because the employee would have given birth and taken leave after her one-year anniversary and thus after she became eligible. The Court said allowing the employer to terminate a pre-eligibility employee for a post-eligibility request is "contrary to the basic concept of the FMLA." Additionally, the Court noted that the Act requires employees to give advance notice to their employees of future leaves. Allowing the woman's termination would have prevented the employee from fulfilling her duty under the statute and would create an incentive not to inform employers of foreseeable leave.

FMLA decision upholds firing for abusing sick time

An airline was protected for terminating an employee for abusing FMLA leave to extend vacations and avoid working on holidays. In that case, the employee had suffered a back injury in an auto accident and requested eight days FMLA per month for medical purposes. Three years later, the airline began questioning whether the employee was instead using his FMLA leave to extend vacation and other time off.

Records indicated that on almost three dozen occasions, the employee had scheduled FMLA just before or after previously-scheduled time off and often used FMLA on holidays. After the employee failed to show up for a Christmas-day shift and the days surrounding and requested FMLA leave for his absences, the airline discovered the employee had booked a flight in June for those dates. After a hearing, the employee was terminated for violating the airline's attendance policies. The former employee then sued the airline, alleging his termination was in retaliation for taking FMLA leave.

A federal court disagreed, holding that the airline was justified in firing the employee for his failure to comply with its attendance program due to its "honest belief" that he misused FMLA leave. Under the Court's holding, while a company may not terminate an employee for legitimate use of FMLA time, it may terminate employees who misuse leave under the statute.

Limitations begin running in securities cases when violation occurs, not when injury is sustained

The Seventh Court of Appeals upheld the dismissal of a securities case on statute of limitations grounds late last year when in a case in which the violation and subsequent injury were five years apart. As part of a 2002 divorce decree, a husband was ordered to pay alimony to his wife. The decree provided, however, that the husband could end his alimony obligations by selling stock he owned in the closely-held corporation in which he worked and transferring the proceeds to his wife. Around that time in 2002, the company's CFO told the wife that the shares could not be sold until the husband died or left the company. That representation turned out to be false. The husband did ultimately sell the stock in 2007, transfer the shares to his former wife, and stop making alimony payments. The wife sued the company in 2009, alleging a violation of the securities laws for the CEO's misrepresentation.

The securities laws provide that a securities fraud case must be brought within two years of

the discovery of the facts constituting a violation of the laws and, at most, within five years of the violation. Here, although the alleged injury occurred in 2007 when the shares were sold and the husband stopped making alimony payments, the misrepresentation by the CEO occurred in 2002—seven years before the suit was filed. The Court agreed that the injury occurred in 2007, but that injury was not necessary to establish a violation of the securities laws. Thus, the suit was two years after the five-year maximum statute of limitations and could no longer be brought. The Court's ruling serves as a positive reassurance for companies that when an alleged securities violation does not lead to injury that would prompt litigation until many years after the violation, the company may be spared shareholder litigation.



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Our Management & Professional Services Team recently co-authored an article with Deloitte Financial Advisory Services on "Internal investigation costs: Securing elusive insurance coverage" that will circulate through Deloitte Forensic Center's *For Thoughts* Newsletter series. Please let Kara Altenbaumer-Price know if you would like to receive a copy once it comes out.

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