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JUDGE RAKOFF AGAIN CRITICIZES SEC SETTLEMENTS. HOW WILL D&O INSURERS RESPOND?

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In a March 21, 2011 opinion by U.S. District Court Judge Jed Rakoff in *Securities and Exchange Commission v. Vitesse Semiconductor Corp., et al.,* Case No. 10cv9239 (S.D.N.Y. March 21, 2011) (the "Opinion"), Judge Rakoff, in approving the proposed consent judgments against Vitesse and two of its officers, questioned whether the SEC's practice of allowing defendants to neither admit nor deny liability might render a proposed consent judgment "so unreasonable or contrary to the public interest as to warrant its disapproval." Here are Judge Rakoff's own words: "[h]ere an agency of the United States is saying, in effect, 'although we claim that these defendants have done terrible things, they refuse to admit it and we do not propose to prove it, but will simply resort to gagging their right to deny it.'"

This is at least the second time that Judge Rakoff has publicly called into question the SEC's settlement practices. In September 2009, Judge Rakoff initially refused to approve a $33 million settlement between the SEC and Bank of America relating to shareholder communications by Bank of America prior to its takeover of Merrill Lynch. Although Judge Rakoff subsequently approved the settlement on revised terms, he chastised the SEC for the initial settlement terms, stating that the settlement "does not comport with the most elementary notions of justice and morality, in that it proposes that the shareholders who were the victims of the Bank's alleged misconduct now pay the penalty for that misconduct."

If Judge Rakoff's reasoning gains traction in judicial or political quarters, the SEC may be placed in a position where it must refuse to enter into settlements with defendants unless the defendants admit liability. This would create a strong disincentive for defendants, and especially individual defendants, to settle with the SEC for at least two reasons: (1) if they admit liability, they will have limited future prospects as directors or officers of any registered company; and (2) the admission of liability will significantly raise the cost of resolving any related civil litigation, such as a securities class action.

In the wake of the *Vitesse* decision, D&O underwriters should be thinking about how the inability to settle SEC enforcement proceedings will affect the costs of defense for SEC enforcement proceedings and impact defense and settlement costs for related shareholder class actions and derivative litigation. On the one hand, if defendants cannot settle with the SEC without admitting liability, there likely will be fewer settlements and some defendants may decide to litigate until a final judgment — all resulting in increased costs of defense. On the other hand, if a defendant chooses to litigate until a final judgment and a verdict is rendered against the defendant, the D&O insurer may be able to deny coverage in its entirety based on conduct exclusions in the D&O policy.

SEC V. VITESSE, ET AL.

On December 10, 2010, the SEC filed an enforcement proceeding against Vitesse Semiconductor Corporation and four Vitesse officers and directors. In its complaint, the SEC generally alleged that the defendants made numerous material misrepresentations in Vitesse's SEC filings in an effort to conceal their fraudulent revenue recognition practices and stock options backdatings. Simultaneously with the filing of the complaint, the SEC filed proposed consent judgments against Vitesse and two of its officers, apparently anticipating that the court would simply approve the settlement as negotiated.

The consent judgments were presented to Judge Rakoff for court approval. According to the Opinion, the consent judgments lacked information explaining why they should be approved and how they met the requisite legal standards for court approval. In response to Judge Rakoff's request for additional information, the SEC provided a December 21, 2010 letter brief. In addition, on December 22, 2010, a hearing was held before Judge Rakoff at which time the parties provided further information.

In the Opinion, Judge Rakoff acknowledged that, at first glance, the terms of the proposed consent judgments appeared inadequate based on the allegations of material misconduct by the defendants. However, despite the fact that the three defendants neither admitted nor denied liability, Judge Rakoff concluded that the terms of the settlement were "fair, reasonable, adequate, and in the public interest." In finding that the terms of the proposed settlement were adequate, Judge Rakoff considered factors outside the terms of the settlement with the SEC, such as the fact that the two officers pled guilty to parallel criminal charges and that Vitesse had little money to pay based on its current troubled financial condition.

Despite having approved the settlement, Judge Rakoff raised concerns with the SEC's longstanding practice of seeking court approval for settlements in which serious allegations of fraud are asserted against the defendants without requiring the defendants to expressly admit or deny the allegations.

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As a practical matter, the SEC's practice of settling with defendants who neither admit nor deny liability benefits both the SEC and the defendants. By entering into the consent judgments without admitting liability, the defendants are not collaterally estopped from asserting their innocence in parallel civil actions. Because the defendants do not have to admit liability, the SEC benefits because the defendants are more likely to enter into SEC settlements at an earlier time, and without requiring the SEC to devote substantial resources to taking enforcement actions to trial.

According to the Opinion, the SEC's practice of entering into settlements where the defendants neither admit nor deny liability began decades ago and has developed through the years. Prior to 1972, after a court approved a settlement, the defendant would publicly deny his or her liability in connection with the SEC's allegations. In response, in 1972, the SEC began to require all defendants who settled with the SEC without an admission of liability to refrain from publicly proclaiming their innocence. Nevertheless, SEC defendants still found ways in which to make it known that they never admitted liability — while being careful to refrain from denying liability at the same time.

In the Opinion, Judge Rakoff questioned whether the SEC's practice of allowing defendants to neither admit nor deny liability might render a proposed consent judgment "so unreasonable or contrary to the public interest as to warrant its disapproval." According to Judge Rakoff, the public suffers from the SEC's practice of allowing the defendants to settle serious allegations without admitting liability, leaving the public with no way of knowing whether there was any truth behind the allegations.

D&O COVERAGE IMPLICATIONS

SEC settlements themselves are generally uninsurable under D&O policies because they are composed of either: (1) fines/penalties; (2) disgorgement; and/or (3) equitable relief. However, the costs associated with defending against SEC enforcement proceedings are generally covered under D&O policies.

As discussed, if Judge Rakoff's reasoning is followed, the SEC may find itself pressured — or obligated — to enter into settlements only with defendants who will admit liability. If defendants cannot settle with SEC without admitting liability, there will be fewer settlements, and some defendants may decide to litigate until a final judgment — all resulting in increased costs of defense. In recent years, defense costs for even a single SEC defendant have run into the millions of dollars, and sometimes even more than $10 million. Because defense fees associated with SEC enforcement proceedings are generally covered under D&O policies, D&O insurers would feel the impact of increased defense costs in SEC actions.

At the same time, if a defendant chooses to litigate until a final judgment and a verdict is rendered *against* the defendant, the D&O insurer may be able to deny coverage for the defendant based on the conduct exclusions. In addition, the D&O insurer may be able to rely on the judgment to deny coverage for one or more D&O defendants in any related civil litigations. Depending upon the policy terms at issue, the D&O insurer may also be able to seek reimbursement of all of the defense costs that it previously advanced following an adverse verdict in an SEC trial.

The SEC's reaction to Judge Rakoff's criticism remains to be seen. Although intended to be an independent regulator, the SEC can be subjected to political pressure — especially from the U.S. Congress, which sets the SEC's annual funding budget. It will be interesting to see if there is a slowdown in SEC settlements over the next few months and if other judges refuse to "rubber stamp" SEC settlements where the defendants neither admit nor deny liability. We will follow this issue and report any findings.

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