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## Admission of Wrongdoing: Increasing Public Accountability in SEC Settlements

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# ADMISSION OF WRONGDOING: INCREASING PUBLIC ACCOUNTABILITY IN SEC SETTLEMENTS

## INTRODUCTION

Recently, Mary Jo White, Chair of the U.S. Securities and Exchange Commission (the SEC or Commission), announced a new SEC settlement policy: in certain cases, the SEC would seek an admission of wrongdoing from parties before agreeing to settle.<sup>1</sup> The new policy marked a sea change in established SEC settlement practice. Previously, parties had routinely been permitted to “neither admit nor deny” wrongdoing in their settlement.<sup>2</sup> The justification for the previous policy was the idea that parties would rather litigate than admit to wrongdoing, out of fear that an admission would subject them to collateral estoppel in related suits.<sup>3</sup> Chair White believes that this justification for “neither admit nor deny” language does not always hold true, especially in particularly egregious cases.<sup>4</sup> She believes that the need for public accountability is great enough that parties in these cases must make an admission of wrongdoing as part of their settlement.<sup>5</sup>

Reaction to the new policy has been mixed. Some critics laud the move as an important step for the Commission in holding settling parties more accountable.<sup>6</sup> Others have questioned the policy, echoing the argument that attempts to extract admissions disincentivize parties from settling.<sup>7</sup>

Criticism of the Commission’s new policy is misplaced on two grounds. First, the SEC’s goal in requiring admissions in certain cases is not to increase settling parties’ collateral liability. In fact, so far the SEC has allowed parties to structure their admissions in such a way that they preclude further collateral liability. This makes sense, given the Commission’s stated purpose in adopting this policy change. Chair White has stated that the SEC revised its settlement practices to increase settling parties’ accountability to the public by establishing “an unambiguous record

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1. James B. Stewart, *The S.E.C. Has a Message for Firms Not Used to Admitting Guilt*, N.Y. TIMES, June 22, 2013, at B1, available at <http://www.nytimes.com/2013/06/22/business/secs-new-chief-promises-tougher-line-on-cases.html>.

2. *Examining the Settlement Practices of U.S. Financial Regulators: Hearing Before the H. Comm. on Financial Services*, 112th Cong. 77 (2012) (statement of Robert Khuzami, Director, Division of Enforcement, SEC) [hereinafter *Hearings*], available at <http://www.gpo.gov/fdsys/pkg/CHRG-112hhrg75734/pdf/CHRG-112hhrg75734.pdf>.

3. *Id.* at 79.

4. Mary Jo White, Chair, SEC, Speech at the Council of Institutional Investors: Deploying the Full Enforcement Arsenal (Sept. 26, 2013), available at <http://www.sec.gov/News/Speech/Detail/Speech/1370539841202>.

5. Stewart, *supra* note 1, at B1.

6. *Id.*

7. Marc Fagel, *The SEC’s Troubling New Policy Requiring Admissions*, 45 BNA SEC. REG. & L. REP. 1172 (2013), available at <http://www.gibsondunn.com/publications/Documents/Fagel-SECs-Troubling-New-Policy-Requiring-Admissions.pdf>.

of the conduct” at issue.<sup>8</sup> In short, the SEC is not seeking an increase in collateral liability for parties by requiring an admission from them. Second, for a variety of reasons, admissions made in SEC consent judgments are not by themselves likely to increase the collateral liability of settling parties.

This Note examines the ramifications of an admission of wrongdoing in an SEC settlement. Part I provides the factual background surrounding the new policy, including recent cases in which the new admissions policy has been applied. Part II examines criticisms of the Commission’s new policy and identifies a number of limitations on collateral liability resulting from settlement admissions. Part III analyzes admissions the SEC has so far extracted and the manner in which these admissions have been structured to limit the admitting party’s collateral liability.

## I. HISTORY OF SEC SETTLEMENT PRACTICE

### A. “NEITHER ADMIT NOR DENY” IN SEC SETTLEMENTS

The SEC has a variety of enforcement powers at its disposal. The Securities Exchange Act of 1934 (the Exchange Act) provides that as part of its mandate to enforce the federal securities laws, the SEC may file a civil enforcement action in federal district court.<sup>9</sup> The SEC may also seek to file an administrative complaint before one of its administrative law judges.<sup>10</sup> Regardless of the chosen means of enforcement in a given case, the vast majority of the actions that the Commission initiates end in settlement.<sup>11</sup> The Commission often makes use of consent decrees when negotiating a settlement.<sup>12</sup> Over ninety percent of the suits initiated by the SEC are settled in this manner.<sup>13</sup>

Consent decrees are “negotiated settlements [between the parties] submitted to a court for approval and entry of a judgment.”<sup>14</sup> Unsurprisingly, such an agreement “normally embodies a compromise” between the Commission and the defending party.<sup>15</sup> In the past, as part of that compromise, settling parties have neither admitted nor denied the underlying factual allegations in the consent decree.<sup>16</sup> In practice, such

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8. White, *supra* note 4.

9. 15 U.S.C. § 78a (2012).

10. *Office of Administrative Law Judges*, SEC, <http://www.sec.gov/alj.shtml> (last modified Mar. 4, 2014).

11. *SEC v. Clifton*, 700 F.2d 744, 748 (D.C. Cir. 1983).

12. *See Hearings*, *supra* note 2, at 77. The Code of Federal Regulations expressly contemplates the use of consent decrees by the SEC. 17 C.F.R. § 202.5(f) (2014) (“In the course of the Commission’s investigations, civil lawsuits, and administrative proceedings, the staff, with appropriate authorization, may discuss with persons involved the disposition of such matters by consent, by settlement, or in some other manner.”).

13. *Clifton*, 700 F.2d at 748.

14. *Hearings*, *supra* note 2, at 76 n.4.

15. *United States v. Armour & Co.*, 402 U.S. 673, 681 (1971).

16. *Hearings*, *supra* note 2, at 77.

language bars the settling party from denying the factual allegations but does not require the defendant to admit to the alleged wrongdoing.<sup>17</sup> The justification for this “neither admit nor deny” policy is that it provides greater incentive for parties to settle.<sup>18</sup> Courts, recognizing the virtues of negotiated settlements,<sup>19</sup> have generally been deferential in approving consent decrees with “neither admit nor deny” language.<sup>20</sup>

In 2012, then-acting SEC Enforcement Division Director Robert Khuzami testified before Congress and spoke at length about the Commission’s settlement practices.<sup>21</sup> He specifically addressed the SEC’s inclusion of “neither admit nor deny” language in consent decrees.<sup>22</sup> Khuzami stated that there would be “far fewer settlements, and much greater delay in resolving matters and bringing relief to harmed investors,” if the SEC had to extract admissions from defendants.<sup>23</sup> Khuzami maintained requiring an admission would handicap the SEC’s ability to settle because such admissions may expose a corporation to additional liability in private suits.<sup>24</sup> Corporate defense attorneys have echoed this concern.<sup>25</sup>

Despite their prevalence, the Commission does not include “neither admit nor deny” language in all of its settlements.<sup>26</sup> The SEC has carved out an important exception to its “neither admit nor deny” policy in cases with pending parallel criminal proceedings.<sup>27</sup> Upon a self-directed review of its settlement policies in 2012, the Commission determined that the inclusion of “neither admit nor deny” language in such cases makes little sense.<sup>28</sup> Specifically, the SEC found it “unnecessary for there to be a ‘neither admit’ provision in those cases where a defendant had been criminally convicted of conduct that formed the basis of a parallel civil enforcement proceeding.”<sup>29</sup>

#### **B. JUDICIAL REVIEW OF “NEITHER ADMIT NOR DENY” CONSENT DECREES**

Despite the purported benefits of the SEC’s prior settlement practices, the Commission’s use of “neither admit nor deny” language has come under

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17. *Id.*

18. *Id.* at 79.

19. *Evans v. Jeff D.*, 475 U.S. 717, 760 n.15 (1986) (Brennan, J., dissenting).

20. *Hearings*, *supra* note 2, at 77.

21. *Id.* at 74.

22. *Id.* at 77.

23. *Id.* at 79.

24. *Id.*

25. Stewart, *supra* note 1, at B1.

26. *Hearings*, *supra* note 2, at 82.

27. Robert Khuzami, Dir., Div. of Enforcement, SEC, Public Statement: Recent Policy Change (Jan. 7, 2012), available at <http://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1365171489600>.

28. *Id.*

29. *Id.*

fire in the aftermath of the financial crisis. One of the more notable critics of the SEC's "neither admit nor deny" policy is Judge Jed S. Rakoff, a federal district court judge sitting in New York's Southern District.<sup>30</sup> In two high-profile cases, Judge Rakoff rejected consent judgments proposed by the SEC because they included "neither admit nor deny" language.<sup>31</sup>

In 2009, the SEC filed a complaint in district court against Bank of America, alleging that the bank materially misled its shareholders in its deal to acquire Merrill Lynch.<sup>32</sup> The same day, the SEC filed a consent judgment that Bank of America had already stipulated to in order to settle the case.<sup>33</sup> Judge Rakoff applied the customary deferential standard in reviewing the consent judgment.<sup>34</sup> Specifically, he wrote that "the Court is . . . obliged to review the proposal . . . to ascertain whether it is within the bounds of fairness, reasonableness, and adequacy—and, in certain circumstances, whether it serves the public interest."<sup>35</sup> Judge Rakoff ruled that the proposed settlement with Bank of America failed to meet even this deferential standard and rejected the consent decree.<sup>36</sup>

Similarly, in 2011, Judge Rakoff refused to approve a \$285 million settlement between the SEC and Citigroup because it contained "neither admit nor deny" language.<sup>37</sup> The SEC alleged that in 2007, Citigroup recognized that mortgage-backed securities were beginning to weaken, dumped them on uninformed investors, and made significant profits off of these transactions while investors suffered large losses.<sup>38</sup>

An agreed-to consent judgment was simultaneously filed with the complaint, subject only to approval by the court.<sup>39</sup> In keeping with prior SEC practice, the consent judgment contained "neither admit nor deny" language.<sup>40</sup> Judge Rakoff refused to approve the consent judgment because of the seriousness of the allegations contained within the SEC's complaint and in supplementary documents.<sup>41</sup> The "neither admit nor deny" language in the consent decree deprived "the Court . . . [of] proven or admitted facts

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30. Stewart, *supra* note 1, at B1.

31. SEC v. Citigroup Global Mkts., Inc., 827 F. Supp. 2d 328 (S.D.N.Y. 2011); SEC v. Bank of Am. Corp., 653 F. Supp. 2d 507 (S.D.N.Y. 2009); *see also* Michael C. Macchiarola, "Hallowed by History, but Not by Reason": Judge Rakoff's Critique of the Securities and Exchange Commission's Consent Judgment Practice, 16 CUNY L. REV. 51 (2012).

32. *Bank of Am.*, 653 F. Supp. 2d at 508.

33. *Id.*

34. *Id.*

35. *Id.* (citing SEC v. Randolph, 736 F.2d 525, 529 (9th Cir. 1984)).

36. *Id.*

37. *See* SEC v. Citigroup Global Mkts., Inc., 827 F. Supp. 2d 328 (S.D.N.Y. 2011); *see also* Edward Wyatt, *Judge Rejects an S.E.C. Deal with Citigroup*, N.Y. TIMES, Nov. 29, 2011, at A1, available at <http://www.nytimes.com/2011/11/29/business/judge-rejects-sec-accord-with-citi.html>.

38. *Citigroup*, 827 F. Supp. 2d at 329.

39. *Id.* at 330.

40. *Id.*

41. *Id.*

upon which to exercise even a modest degree of independent judgment.”<sup>42</sup> Without such facts, the district court held that it could not determine the propriety of the consent decree and therefore rejected it.<sup>43</sup>

In the aftermath of Judge Rakoff’s ruling, both the SEC and Citigroup pursued interlocutory appeals of the rejection of the consent decree.<sup>44</sup> The Second Circuit stated that the district court had overstepped its bounds in rejecting the consent judgment, declaring that “it is not the proper function of federal courts to dictate to executive administrative agencies what policies will best serve the public interest.”<sup>45</sup> The Second Circuit stayed further district court proceedings pending a full appeal of the district court ruling.<sup>46</sup>

### C. RECENT CHANGES IN SEC SETTLEMENT POLICY

Recently, the Commission changed its stance on admissions in settlements.<sup>47</sup> Soon after being approved as the new Chair of the SEC, Mary Jo White announced a new policy where the Commission would in certain cases seek an admission of wrongdoing from settling parties.<sup>48</sup> In announcing the new policy, Chair White emphasized that the majority of cases could still be settled by a party without an admission of wrongdoing.<sup>49</sup>

In a recent speech, Chair White described the types of future cases in which the Commission would seek an admission of wrongdoing.<sup>50</sup> Specifically, she referenced cases where

a large number of investors have been harmed or the conduct was otherwise egregious . . . , cases where the conduct posed a significant risk to the market or investors . . . , cases where admissions would aid investors deciding whether to deal with a particular party in the future . . . , [and] cases where reciting unambiguous facts would send an important message to the market about a particular case.<sup>51</sup>

Rather than strict criteria for seeking an admission, these listed factors are to be considered within the context of an individual case in order to determine whether an admission is warranted.<sup>52</sup>

Chair White’s concern in articulating this new policy is with increasing settling parties’ accountability to the public.<sup>53</sup> An admission of wrongdoing

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42. *Id.*

43. *Id.*

44. SEC v. Citigroup Global Mkts., Inc., 673 F.3d 158, 160 (2d Cir. 2011).

45. *Id.* at 164–65 n.3.

46. *Id.* at 169.

47. Stewart, *supra* note 1, at B1.

48. *Id.*

49. *Id.*

50. White, *supra* note 4.

51. *Id.*

52. See Stewart, *supra* note 1, at B1.

53. White, *supra* note 4.

increases accountability because it “creates an unambiguous record of the conduct and demonstrates unequivocally the defendant’s responsibility for his or her acts.”<sup>54</sup> Chair White emphasized her experience as a federal prosecutor when announcing the new policy.<sup>55</sup> In reviewing the Commission’s settlement policies, Chair White analogized an admission to the powerful effect of a guilty plea in establishing an unambiguous factual record of the conduct at issue.<sup>56</sup> She believes that some SEC enforcement actions require just such an unambiguous factual record for the sake of transparency.<sup>57</sup>

The emphasis upon accountability that underlies the Commission’s new policy dovetails with the SEC’s stated enforcement goals.<sup>58</sup> In a recent speech, Chair White emphasized her belief in the importance of the public nature of the SEC’s enforcement actions, both to parties within the financial markets and without.<sup>59</sup> She believes the SEC needs “to have a presence everywhere and be perceived to be everywhere bringing enforcement actions against violators in every market participant category and in every market strata.”<sup>60</sup> The new admissions policy furthers this important institutional goal because it creates a clear factual record that the public can rely on.<sup>61</sup>

#### **D. REACTIONS TO THE NEW SEC ADMISSIONS POLICY**

Reaction to the SEC’s new policy has been mixed. Professor John Coffee of Columbia University, a historically vocal critic of what he has called overly lenient SEC settlements, thinks that requiring admissions in some cases is “an important step in the right direction.”<sup>62</sup> Professor Coffee asserts that the new policy is an important acknowledgement of the increasing public demand for accountability in financial enforcement actions, especially in the aftermath of the financial crisis.<sup>63</sup> His comments echo Chair White’s emphasis on the importance of an unambiguous record that details what conduct actually took place.<sup>64</sup>

Corporate defense attorneys are decidedly less optimistic than Professor Coffee about the new policy. Brad Karp, a litigator for Paul, Weiss, Rifkind, Wharton & Garrison LLP who represented Citigroup in its SEC

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54. *Id.*

55. Stewart, *supra* note 1, at B1.

56. *Id.*

57. *Id.*

58. White, *supra* note 4.

59. *Id.*

60. *Id.*

61. *Id.*

62. Stewart, *supra* note 1, at B1.

63. *Id.*

64. White, *supra* note 4.

filing, has expressed serious concerns about the new admissions policy.<sup>65</sup> The biggest concern articulated by Mr. Karp, and echoed by others,<sup>66</sup> is that the new policy may incentivize litigation because an admission in a consent judgment may expose a financial institution to collateral liability.<sup>67</sup> As a result, it may be in the best interests of these parties to go to trial rather than to settle and admit to any wrongdoing.<sup>68</sup> In sum, defense counsel's concern is that the SEC's new policy will increase expensive, contested litigation with well-funded and highly motivated opposing parties.<sup>69</sup> Such litigation may take years before any trial verdict is obtained.<sup>70</sup>

Defense counsel raise further concerns about the SEC's institutional capability to engage in this type of protracted litigation. This increase in litigation may consume so much of the Commission's limited resources that it may have a trickle-down effect, actually making the SEC less effective at regulating the securities markets.<sup>71</sup> Because the SEC will have to devote more resources to protracted litigation involving parties unwilling to make an admission, they argue, the Commission's ability to effectively monitor and prevent future securities fraud and other types of misconduct will be compromised.<sup>72</sup> As mentioned, the protracted and complicated nature of this sort of litigation means that these trials could take years.<sup>73</sup> These concerns rest on the presumption that the SEC's new policy will necessarily result in more litigation.

#### E. ADMISSIONS MADE UNDER THE NEW POLICY

The SEC extracted its first admission of wrongdoing on August 19, 2013, in its settlement with Phillip Falcone, manager of Harbinger Capital Partners.<sup>74</sup> Mr. Falcone admitted to improper use of fund assets and other acts of misconduct towards investors.<sup>75</sup> This settlement agreement was preceded by an earlier offer from the SEC's Enforcement Division that did not require Mr. Falcone to admit any wrongdoing, but that offer was later

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65. Stewart, *supra* note 1, at B1.

66. Thomas A. Zaccaro et al., *SEC's Guilt Admission Policy May Bring Pricey Trials*, L. 360 (July 3, 2013, 1:40 PM), available at <http://www.paulhastings.com/docs/default-source/the-way-we-work---publications/secs-guilt-admission-policy-may-bring-pricey-trials.pdf>.

67. Fagel, *supra* note 7, at 1172.

68. *Id.*

69. *Id.*

70. *Id.*

71. *Id.*

72. *Id.*

73. *Id.*

74. Press Release, SEC, Phillip Falcone and Harbinger Capital Agree to Settlement (Aug. 19, 2013), available at <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539780222#.UkRxdlasgk0>.

75. *Id.*



withdrawn by the Commission for being too lenient.<sup>76</sup> Mr. Falcone's admission set an important first precedent for the SEC, especially in relation to more high-profile cases like the JPMorgan "London Whale" trading disaster.<sup>77</sup>

The SEC's hope to pressure JPMorgan into providing an admission in the London Whale case ultimately came to fruition when the Commission reached a \$920 million settlement with the financial services provider.<sup>78</sup> The settlement also included an admission of wrongdoing by the bank for failing to catch traders hiding losses.<sup>79</sup> JPMorgan's admission of wrongdoing was an important prerequisite for SEC approval of the settlement.<sup>80</sup>

The wording of JPMorgan's admission is important because it limits further collateral liability on the part of the bank.<sup>81</sup> In its settlement, JPMorgan admitted to having inadequate internal risk controls in place, not to committing any sort of fraudulent activity.<sup>82</sup> Such an admission limits JPMorgan's liability significantly because it does not expose the bank to liability in a shareholder class action for fraud.<sup>83</sup> Such a suit typically requires proof of an intentional fraud, and JPMorgan's admission has no bearing on that issue.<sup>84</sup>

Some have criticized the SEC for the limited nature of JPMorgan's admission. Adam Pritchard, a University of Michigan law professor, characterized the settlement as a "show of an admission" without any real consequences.<sup>85</sup> Regardless of the actual effect of JPMorgan's admission, it creates an uncontroverted and unambiguous factual record of the London Whale trades. This settlement remains one of the most high-profile implementations of the Commission's new policy to date.

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76. Alexandra Stevenson, *Falcone to Admit to Wrongdoing as S.E.C. Takes a Harder Line*, N.Y. TIMES DEALBOOK (Aug. 19, 2013, 5:15 PM), <http://dealbook.nytimes.com/2013/08/19/hedge-fund-manager-to-admit-to-wrongdoing-in-revised-deal-with-s-e-c/>.

77. *Id.*

78. Joshua Gallu, *JPMorgan Guilty Admission a Win for SEC's Policy Shift*, BLOOMBERG (Sept. 20, 2013, 12:01 AM), <http://www.bloomberg.com/news/2013-09-19/jpmorgan-s-guilty-admission-marks-victory-in-sec-s-policy-shift.html>; see also Press Release, SEC, JPMorgan Chase Agrees to Pay \$200 Million and Admits Wrongdoing to Settle SEC Charges (Sept. 19, 2013), available at <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539819965#.UzyzbfldWSp>.

79. Press Release, SEC, JPMorgan Chase Agrees to Pay \$200 Million and Admits Wrongdoing to Settle SEC Charges (Sept. 19, 2013), available at <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539819965#.UzyzbfldWSp>.

80. Gallu, *supra* note 78.

81. *Id.*

82. JPMorgan Chase & Co., Exchange Act Release No. 70,458, Accounting and Auditing Release No. 3490, 2013 WL 5275772, annex A at 4 (Sept. 19, 2013) [hereinafter JPMorgan Consent Decree], available at <http://www.sec.gov/litigation/admin/2013/34-70458.pdf>.

83. Gallu, *supra* note 78.

84. *Id.*

85. *Id.*

## II. CRITICISM OF THE NEW ADMISSIONS POLICY

The SEC's new admissions policy has been criticized for disincentivizing parties from settling with the Commission. This critique rests on the idea that an admission of wrongdoing will increase a settling party's collateral liability. Specifically, critics predict an increase in collateral liability in shareholder class actions based on the same underlying facts as the SEC enforcement action and an increase in Directors' and Officers' Liability Insurance costs. Instead of admitting to wrongdoing and incurring these additional liabilities, parties to SEC enforcement actions will instead choose to fully litigate the dispute at trial. This concern with the extension of liabilities and costs, however, is ameliorated by the special nature of consent judgments—the SEC's preferred means of settlement.

### A. INCREASE IN COLLATERAL LIABILITY FOR ADMITTING PARTIES

Commentators critical of the new SEC settlement policy have argued that an admission of wrongdoing unacceptably extends settling parties' collateral liability in subsequent class actions arising out of the same set of facts. Professor Coffee nicely summarizes these concerns.<sup>86</sup> First, critics of the new policy argue that an admission may serve as a form of offensive collateral estoppel barring the settling party from contesting the admitted to issue in future suits.<sup>87</sup> Second, critics think that even if settling parties are not collaterally estopped from contesting the admitted-to issue, the admission itself would not be excludable evidence in a future jury trial.<sup>88</sup>

Collateral estoppel is a doctrine that limits a party “from relitigating facts resolved adversely to them in a prior equitable proceeding with another party.”<sup>89</sup> Offensive collateral estoppel refers to the use of collateral estoppel by a plaintiff “seeking to estop a defendant from relitigating the issues which the defendant previously litigated and lost against another plaintiff.”<sup>90</sup> Critics of the new policy are concerned that future class-action plaintiffs may use an SEC settlement admission to collaterally estop an admitting party from contesting the admitted-to issue.<sup>91</sup>

The offensive collateral estoppel concern with the SEC's new admissions policy rests in large part on the holding in *Parklane Hosiery v. Shore*.<sup>92</sup> In that case, the Supreme Court held that plaintiffs in a proxy fraud class action properly invoked offensive collateral estoppel on issues that

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86. John C. Coffee Jr., *'Neither Admit Nor Deny': Practical Implications of SEC's New Policy*, N.Y.L.J., July 18, 2013, at 5.

87. *Id.*

88. *Id.*

89. *Parklane Hosiery Co. v. Shore*, 439 U.S. 322, 326 (1978).

90. *Id.* at 329.

91. Coffee, *supra* note 86, at 5.

92. *Id.*

had already been adjudicated in an earlier SEC trial.<sup>93</sup> Given that the “petitioners received a ‘full and fair’ opportunity to litigate their issues” in the preceding SEC action, the Court held that offensive collateral estoppel applied in this case.<sup>94</sup> The Court cabined its decision by giving broad discretion to the district court in determining whether offensive collateral estoppel is appropriate in a given case.<sup>95</sup> The appropriate inquiry for the exercise of this discretion is whether collateral estoppel of an issue is appropriate or “would be unfair to a defendant.”<sup>96</sup>

In the aftermath of *Parklane*, it is apparent that in some instances a party may be collaterally estopped from contesting certain issues it has already litigated in future securities class actions. An admission in an SEC settlement, however, would not warrant the application of offensive collateral estoppel.<sup>97</sup> The key factor for the Court in *Parklane* was the “full and fair” opportunity that the previous SEC *trial* had afforded the petitioners in fully litigating the contested issue.<sup>98</sup> An admission in a consent judgment does not present the same opportunity for a party to contest a factual issue because of the negotiated nature of the judgment.

Consent decrees, the SEC’s preferred method of settlement,<sup>99</sup> are unique in many ways. One such aspect of consent decrees is that they do not constitute an adjudication of factual claims.<sup>100</sup> In one case, in which the relevant consent decree purported to be “an admission of fault,” the Supreme Court stated in dicta that consent decrees do “not . . . adjudicate” the underlying claims at issue.<sup>101</sup> This view is consistent with the Restatement of Judgments, which provides that the “central characteristic of a consent judgment is that the court has not actually resolved the substance of the issues presented.”<sup>102</sup>

Because a consent decree is non-adjudicatory by nature, an admission therein does not amount to the “full” and “fair” opportunity to litigate that *Parklane* requires.<sup>103</sup> Since a consent judgment does not present such an opportunity, any admission made within such a judgment could not be used to collaterally estop a party from contesting a claim under *Parklane*.<sup>104</sup> In

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93. *Parklane*, 439 U.S. at 333.

94. *Id.* at 332.

95. *Id.* at 331.

96. *Id.*

97. Coffee, *supra* note 86, at 5.

98. *Parklane*, 439 U.S. at 332.

99. *See Hearings*, *supra* note 2, at 77.

100. RESTATEMENT (SECOND) OF JUDGMENTS § 27 (1982).

101. *Maher v. Gagne*, 448 U.S. 122, 126 n.8 (1980).

102. RESTATEMENT (SECOND) OF JUDGMENTS § 27.

103. *Parklane*, 439 U.S. at 332.

104. Coffee, *supra* note 86, at 5; *see also* 18 JAMES WM. MOORE ET AL., MOORE’S FEDERAL PRACTICE 132.03 (3d ed. 1997) (“Issue Preclusion does not apply when the issues sought to be precluded in a subsequent proceeding were allegedly determined in a stipulation or a judgment by consent.”).

that respect, then, commentators' concern with the new SEC admissions policy impermissibly extending liability through collateral estoppel is unfounded. *Parklane* is a distinguishable case for a settling party that has made an admission in a consent decree.

Commentators are also concerned that a settling party's admission would be admissible in evidence during the jury trial portion of future class actions.<sup>105</sup> Federal Rule of Evidence 408 ("Compromise Offers and Negotiations") addresses this particular concern.<sup>106</sup> Rule 408 provides that

evidence of the following is not admissible . . . : either to prove or disprove the validity or amount of a disputed claim or to impeach by a prior inconsistent statement or a contradiction . . . [including] conduct or a statement made during compromise negotiations about the claim — except when offered in a criminal case and when the negotiations related to a claim by a public office in the exercise of its regulatory, investigative, or enforcement authority.<sup>107</sup>

By its own language, the Rule definitively bars statements made "during compromise" negotiations from being admitted into evidence in subsequent suits.<sup>108</sup> Any admissions made in preliminary settlement talks with the SEC are therefore not admissible at a future trial.<sup>109</sup>

The question remains, however, of whether Rule 408 allows for the admission into evidence of statements made in a party's final settlement agreement.<sup>110</sup> While no case has squarely decided this issue, there is case law that suggests even admissions made in a final settlement agreement would be inadmissible in subsequent trials.<sup>111</sup> The courts have consistently interpreted Rule 408 as representing a general policy "that seeks to encourage dispute resolution by barring the admissibility of even completed settlement agreements."<sup>112</sup> Admissions are therefore likely to be excluded in future class actions because courts want to encourage parties to settle.<sup>113</sup> A contrary rule would disincentivize settlements and run counter to the established policy underlying Rule 408.<sup>114</sup>

The exception provided for in Rule 408 also bears on the issue of whether an admission made in a settlement could be offered into evidence in future cases.<sup>115</sup> That exception provides that an admission may not be entered into evidence except "when offered in a criminal case and the

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105. Coffee, *supra* note 86, at 5.

106. *Id.*

107. FED. R. EVID. 408.

108. *Id.*

109. Coffee, *supra* note 86, at 5.

110. *Id.*

111. *Id.*

112. *Id.*

113. *Id.*

114. *Id.*

115. *Id.*

negotiations related to a claim by a public office in the exercise of its regulatory, investigative, or enforcement authority.”<sup>116</sup> The plain language of this Rule applies to admissions obtained from a regulatory agency that federal prosecutors may subsequently enter into evidence in a parallel criminal case.<sup>117</sup> This exception is notably silent on the issue of private class actions. Because of this statutory silence, defense attorneys can argue that the clear legislative intent behind Rule 408 is to allow the use of admissions in criminal cases only and to “preclude” their use in future civil actions.<sup>118</sup> In addition to the general policy encouraging settlements, defense attorneys can rely on this statutory language to exclude an admission from evidence at a subsequent trial.

Though SEC settlement admissions may not damage parties at the trial stage of subsequent class actions, these admissions may have a significant effect on the cost of pre-trial proceedings for the settling parties.<sup>119</sup> An admission in an SEC settlement may prove to be a highly effective weapon for shareholder plaintiffs in their pleadings and briefs because “courts have long shown a marked tendency not to dismiss class actions brought in the wake of SEC consent decrees, and the settlement amounts in those cases are typically higher.”<sup>120</sup> The increased cost of these pre-trial proceedings is an accurate criticism of the Commission’s new policy but does not amount to the wholesale extension of collateral liability predicted by some commentators.

### **B. INCREASE IN D&O INSURANCE COSTS**

The SEC’s admissions policy may also increase insurance costs for companies. Specifically, the new admissions policy may make it more expensive for a company to obtain and maintain Directors’ and Officers’ Liability Insurance (D&O).<sup>121</sup> As a general matter, D&O protects directors and officers “from liability arising from actions connected to their corporate positions.”<sup>122</sup> D&O may take many forms; the corporation could indemnify its directors and officers itself, or their liabilities may be covered by an outside insurance policy.<sup>123</sup> Parties are already prohibited from utilizing

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116. FED. R. EVID. 408(a)(2).

117. Coffee, *supra* note 86, at 5.

118. *Id.*

119. *Id.*

120. *Id.*

121. See Kevin M. LaCroix, *More About the D&O Insurance Implications of the SEC’s New Admissions Wrongdoing Requirements*, LEXISNEXIS LEGAL NEWSROOM (Oct. 21, 2013, 11:24 AM), <http://www.lexisnexis.com/legalnewsroom/corporate/b/blog/archive/2013/10/21/more-about-the-d-and-o-insurance-implications-of-the-sec-39-s-new-admissions-wrongdoing-requirements.aspx>.

122. David M. Gische & Meredith E. Werner, *Directors’ and Officers’ Liability Insurance: An Overview*, CNA MGMT. & PROF. LIABILITY, 5 (June 2011), <http://www.cnapro.com/pdf/DO%20Liability%20Ins%20Ovr%2015-11.pdf>.

123. *Id.* at 5–8.

their D&O to pay out penalties in settlements,<sup>124</sup> so the new policy has no effect on that aspect of D&O coverage. The typical D&O policy does, however, require the insurer to pay attorneys' fees for actions arising out of management's corporate positions, including SEC enforcement actions.<sup>125</sup> Corporate defense fees in large-scale securities suits often amount to millions of dollars.<sup>126</sup> The concern with the SEC's new policy is that an insurer may be able to use a settlement admission as affirmative justification to preclude a settling party from recovering costs in accordance with its D&O policy.<sup>127</sup> The denial of coverage for costs may also extend to subsequent private suits arising out of the same set of facts.<sup>128</sup>

D&O policies typically contain a number of limiting provisions that preclude recovery on a policy if triggered.<sup>129</sup> Conduct exclusions are one type of limiting provision included in almost all D&O policies.<sup>130</sup> Conduct exclusions preclude coverage of directors and officers who have committed certain types of misconduct, including "loss relating to fraudulent or criminal misconduct and for loss relating to illegal profits or remuneration."<sup>131</sup> Importantly, however, most conduct exclusions include an "adjudication" triggering clause, requiring a final adjudication to find that the underlying conduct at issue has actually occurred in order for the exclusion to apply and for coverage to be barred.<sup>132</sup>

In an SEC settlement where a party admits to wrongdoing, a D&O insurer may argue that the admitted behavior falls within the ambit of the conduct exclusion.<sup>133</sup> Depending on the type of SEC action at issue, an insurer may also argue that an admission amounts to a final adjudication of the claim, triggering the conduct exclusion and barring the insured from collecting on their D&O coverage in suits arising out of the same set of facts.<sup>134</sup> The possibility of triggering conduct exclusions with an admission contrasts with the SEC's prior policy; "neither admit nor deny" language could not constitute an "adjudication" because such language does not imply that the underlying conduct at issue has occurred.

That being said, the special nature of consent decrees is again relevant here. Consent decrees do "not . . . adjudicate" the underlying claims at

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124. Eric G. Barber, *Recent Changes in SEC Enforcement Policy Require Renewed Attention to Directors' and Officers' Insurance Terms*, PERKINS COIE LLP (Oct. 17, 2013), <http://www.perkinscoie.com/recent-changes-in-sec-enforcement-policy-require-renewed-attention-to-directors-and-officers-insurance-terms-10-17-2013/>.

125. Gische & Werner, *supra* note 122, at 9.

126. *Id.* at 1.

127. Barber, *supra* note 124.

128. *Id.*

129. Gische & Werner, *supra* note 122, at 14.

130. Barber, *supra* note 124.

131. Gische & Werner, *supra* note 122, at 14.

132. *Id.* at 15.

133. Barber, *supra* note 124.

134. *Id.*

issue.<sup>135</sup> They do not present a “full” and “fair” opportunity to litigate a dispute.<sup>136</sup> Instead, they represent “a compromise” between the Commission and the defending party.<sup>137</sup> For these reasons, an insurer may not be able to successfully argue that an admission made in an SEC settlement triggers a conduct exclusion because a consent judgment is not an adjudication.

The nature of the enforcement action at issue is also potentially significant. An admission in an administrative proceeding may be more desirable for an admitting party because these proceedings do not require court approval of the consent decree.<sup>138</sup> The admitting party in such an action can argue that conduct exclusions cannot be triggered by a non-adjudicatory decree negotiated by the parties not subject to court approval.<sup>139</sup>

Conduct exclusion provisions are typically followed by severability clauses providing that “acts or knowledge of one insured will not be imputed to any other insured for the purpose of applying the exclusion.”<sup>140</sup> The practical effect of this clause is that it bars coverage under the D&O policy only for those individuals whose actions or knowledge underlie the claim at issue.<sup>141</sup> Severability clauses related to exclusions are only triggered when the previously mentioned conduct exclusions are triggered.<sup>142</sup>

Of most concern to settling parties are severability provisions related to applications for D&O coverage.<sup>143</sup> Importantly, these severability provisions “can be implicated even when the admissions do not rise to the level of triggering a conduct exclusion.”<sup>144</sup> As part of the D&O application process, insurers often insist that the prospective insured make certain representations about particular facts in its initial application for D&O coverage.<sup>145</sup> Depending on the language and representations contained in the particular policy at issue, an insurer may argue that an admission in an SEC settlement rescinds the D&O agreement because of the application’s severability provision.<sup>146</sup> If successful, the insured could lose D&O coverage in suits arising out of the same set of facts underlying the settled SEC claim.<sup>147</sup>

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135. *Maier v. Gagne*, 448 U.S. 122, 126 n.8 (1980).

136. *See Parklane Hosiery Co., Inc. v. Shore*, 439 U.S. 322, 332 (1978).

137. *United States v. Armour & Co.*, 402 U.S. 673, 681 (1971).

138. Barber, *supra* note 124.

139. *Id.*

140. Gische & Werner, *supra* note 122, at 14.

141. *Id.* at 14.

142. Barber, *supra* note 124.

143. *See id.*

144. *Id.*

145. *Id.*

146. LaCroix, *supra* note 121.

147. Barber, *supra* note 124.

That being said, severability provisions in D&O policies are limited to the particular individuals making the representation in the application.<sup>148</sup> Well-drafted severability provisions of this type only preclude recovery if the individual that made the application admitted to wrongdoing in an SEC settlement.<sup>149</sup> Insurers are therefore likely unable to preclude recovery on these grounds, provided the application agreement is sufficiently limited, as it likely is.<sup>150</sup>

Insurers may also try to recoup funds they have already advanced to parties for their defense, under the theory that a particular admission triggers a conduct exclusion under the insurance policy.<sup>151</sup> The same factors weighing against the triggering of conduct exclusions apply here. A number of other factors also weigh against an insurance company seeking recoupment, including the fact that by the time the insurer seeks to recover funds that they had advanced, it is likely that any individuals they hope to recover from will have few remaining assets.<sup>152</sup> Though efforts at recoupment by D&O insurers are relatively rare,<sup>153</sup> attempted recoupment is a common enough occurrence that it may increase the scope of liability for a party making an admission under the SEC's new settlement policy.<sup>154</sup> Recoupment is likely the only ground on which an insurer may claw back money provided for costs because of an admission made in an SEC settlement.<sup>155</sup>

### III. LIMITING LIABILITY IN ADMISSIONS OF WRONGDOING

The actual implementation of the SEC's new admissions policy has not proven as catastrophic as some of its opponents have predicted. In the cases where an admission has been made, the admission has been structured in such a manner that it limits the settling party's future liability.<sup>156</sup> This development anticipates and ameliorates corporate defense attorneys' concerns with the new policy. Mr. Karp, a corporate defense attorney, has said that defendants in SEC enforcement actions will "try to find every way possible to avoid" collateral liability from an admission.<sup>157</sup> That being said, he also predicted that "if they can negotiate around it, there will be early settlements."<sup>158</sup> Mr. Karp's words have proven prophetic, at least in regards to the admissions so far obtained. Both the Harbinger and JPMorgan

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148. LaCroix, *supra* note 121.

149. Barber, *supra* note 124.

150. *See id.*

151. *Id.*

152. LaCroix, *supra* note 121.

153. *Id.*

154. *Id.*

155. *Id.*

156. *See* Gallu, *supra* note 78; *see also* Lacroix, *supra* note 121.

157. Stewart, *supra* note 1, at B1.

158. *Id.*



admissions are carefully tailored to avoid any further collateral liability for the settling parties.<sup>159</sup> An in-depth examination of both of these cases is instructive in this regard.

Harbinger and Mr. Falcone admit to the misconduct the SEC alleged in their enforcement action in Appendix A of the consent decree.<sup>160</sup> Harbinger's admission of wrongdoing contains specific language forbidding the defendants from denying any of the factual representations contained in their admission.<sup>161</sup> Such language accords with prior SEC practice.<sup>162</sup> Specifically, Harbinger is bound not to "take any action or make or permit to be made any public statement denying, directly or indirectly, any allegation in the complaints or creating the impression that the complaints are without factual basis."<sup>163</sup> In short, Mr. Falcone is prohibited from denying the admission of wrongdoing contained in the settlement.

The very same paragraph, however, contains important language that limits Harbinger's liability in future suits arising under the same set of facts.<sup>164</sup> The consent decree provides that the Harbinger defendants' admission in no way affects their "right to take legal or factual positions in litigation or other legal proceedings in which the Commission is not a party."<sup>165</sup> This language signifies that Harbinger's admission in the SEC enforcement action will not collaterally estop it from contesting its liability on the same issues in an action with a third party, including Harbinger's D&O insurance provider.

Mr. Falcone has not escaped completely unscathed from his admission. Relying on the admission made in his settlement with the SEC, a New York regulator recently punished Mr. Falcone in an unrelated case.<sup>166</sup> The regulator, Benjamin M. Lawsky, banned Mr. Falcone from controlling insurance companies in the state of New York for seven years.<sup>167</sup> This collateral consequence is important because Harbinger owns Fidelity and Guaranty Life Insurance.<sup>168</sup> The effect of the ban is that Mr. Falcone is unable to serve as an officer or director of the subsidiary insurer.<sup>169</sup> The

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159. See JPMorgan Consent Decree, *supra* note 82; see also Consent of Defendants Philip A. Falcone; Harbinger Capital Partners LLC; Harbinger Capital Partners Offshore Manager, L.L.C.; and Harbinger Capital Partners Special Situations GP, L.L.C., SEC v. Falcone, Nos. 12 Civ. 5027 and 12 Civ. 5028 (S.D.N.Y. Aug. 19, 2013) [hereinafter Falcone Consent Decree], available at <http://www.sec.gov/litigation/litreleases/2013/consent-pr2013-159.pdf>.

160. Falcone Consent Decree, *supra* note 159, at 2.

161. *Id.* at 5.

162. *Hearings*, *supra* note 2, at 79.

163. Falcone Consent Decree, *supra* note 159, at 5.

164. *Id.*

165. *Id.*

166. See Alexandra Stevenson & Ben Protess, *Legal Side Effect in Admission of Wrongdoing to the S.E.C.*, N.Y. TIMES DEALBOOK (Oct. 7, 2013, 12:32 PM), <http://dealbook.nytimes.com/2013/10/07/new-york-regulator-bans-falcone-from-insurance-business/>.

167. *Id.*

168. *Id.*

169. *Id.*

basis of the ban was an expansive New York law allowing regulators to prevent an individual from overseeing insurance companies if they are “untrustworthy.”<sup>170</sup> Mr. Lawsy used Mr. Falcone’s admission in the Harbinger settlement to establish him as an “untrustworthy” individual and effect the ban.<sup>171</sup> Given the limited nature of this collateral consequence,<sup>172</sup> it remains to be seen if this will deter future parties from making an admission in a settlement with the Commission.

Similar to Harbinger’s settlement, JPMorgan’s admission of liability also proscribes future liability.<sup>173</sup> JPMorgan admits to the misconduct detailed in Annex A of the consent decree.<sup>174</sup> The decree, however, expressly provides that “the findings herein . . . are not binding on any other person or entity in this or any other proceeding.”<sup>175</sup> Like the Harbinger consent decree, the express terms of JPMorgan’s admission do not collaterally estop it from contesting the same issues in suits arising out of the same set of facts. Furthermore, JPMorgan structured its admission in such a manner that it admitted to a failure of internal risk controls, not to fraud.<sup>176</sup> Fraud is usually a prerequisite for private suits brought by shareholders.<sup>177</sup> Even if a court were to disregard the expressly limited nature of JPMorgan’s consent decree,<sup>178</sup> the bank’s admission to inadequate risk controls would not establish liability in a future plaintiff shareholder suit.<sup>179</sup> The ability of counsel in future cases to structure settlements along these lines will curtail settling parties’ collateral liability and incentivize more admissions.

It’s important to note that the SEC pursued different enforcement actions in these two cases. Harbinger’s settlement resulted from an enforcement action before a federal district judge.<sup>180</sup> JPMorgan’s, in contrast, was an administrative proceeding before one of the SEC’s administrative law judges.<sup>181</sup> For a variety of reasons, collateral liability resulting from admissions made in a consent decree is circumscribed in both types of actions. Administrative proceedings may offer even more favorable conditions to settling parties, though, because these proceedings do not require court approval.<sup>182</sup> An administrative proceeding therefore constitutes even less of a “fair” and “full” opportunity to litigate a dispute.

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170. *Id.*

171. *Id.*

172. The New York law at issue is only applicable to insurance companies. *Id.*

173. JPMorgan Consent Decree, *supra* note 82.

174. *Id.* at 1.

175. *Id.* at 2 n.1.

176. *Id.* annex A at 4; *see also* Gallu, *supra* note 78.

177. *See* Gallu, *supra* note 78.

178. JPMorgan Consent Decree, *supra* note 82, at 2 n.1.

179. Gallu, *supra* note 78.

180. Falcone Consent Decree, *supra* note 159, at 5.

181. *See* JPMorgan Consent Decree, *supra* note 82.

182. Barber, *supra* note 124.

If viewed in a cynical light, the aforementioned settlements could be interpreted as a failure of the SEC's new policy. The settling parties' liability in future suits is carefully circumscribed by the very terms of the consent judgments. If the Commission's stated purpose of accountability is kept in mind, however, it is clear that the SEC effected this goal in both cases. There now exists "an unambiguous record of the conduct" at issue in both of these cases.<sup>183</sup> Contrast that positive factual record with the result that would have occurred under the previous "neither admit nor deny" policy, where a party would settle without ever specifying the conduct at issue.

### CONCLUSION

Criticism of the SEC's new admissions policy for increasing a settling party's liability is misplaced. No doubt, the Commission has more effective weapons in its enforcement arsenal than extending settling parties' collateral liability in suits with third parties and driving up insurance costs. More importantly, such criticisms miss the point of the new policy. Chair White's stated purpose in seeking admissions in certain cases is to increase public accountability,<sup>184</sup> a particularly relevant concern in the aftermath of the financial crisis. In seeking admissions in certain cases, the SEC is pursuing accountability and transparency through the creation of an unambiguous factual record of the conduct at issue.<sup>185</sup> In pursuing this goal, the SEC has allowed parties to structure their admissions in such a way that they expressly limit future liability, provided the parties admit to the conduct at issue for the purposes of the enforcement action. This demonstrated willingness on the part of the SEC to compromise with settling parties will no doubt be a decisive factor moving forward in extracting future admissions.

Furthermore, the SEC's new policy does not in fact increase settling parties' collateral liability. This is in large part due to the special nature of consent decrees. These decrees are non-adjudicatory because they represent a negotiated compromise between the parties. The non-adjudicatory nature of a consent decree does not present a full and fair opportunity to litigate an issue, and therefore offensive collateral estoppel is not available to shareholder plaintiffs on the basis of an admission.<sup>186</sup> A consent decree admission would likely be excluded under the Federal Rules of Evidence from a jury trial for similar reasons.<sup>187</sup> Furthermore, an admission would likely not preclude a corporation from collecting on its D&O.<sup>188</sup> Even if the

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183. White, *supra* note 4.

184. Stewart, *supra* note 1, at B1.

185. Coffee, *supra* note 86, at 5.

186. *Id.*; see also MOORE ET AL., *supra* note 104, at 132.03.

187. Coffee, *supra* note 86, at 5.

188. LaCroix, *supra* note 121.

SEC in the future is unwilling to accept a hedged admission by a settling party, then the special nature of consent judgments limits any resulting collateral liability to third parties.

Taken together, the SEC's willingness to negotiate with parties and the limited nature of the collateral liability resulting from consent judgments signify that the criticisms leveled against the Commission's new admissions policy are overstated.

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