August 22, 2017

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New York Law Journal

SERVING THE BENCH AND BAR SINCE 1888

WWW.NYLJ.COM

An ALM Publication

VOLUME 258—NO. 37

WEDNESDAY, AUGUST 23, 2017

OUTSIDE COUNSEL

Expert Analysis

Understanding Insurance Issues In Securities Arbitration and Mediation

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Courtesy photos

Insurance issues often influence the outcome of securities arbitrations and mediations, yet the workings of errors and omissions insurance is not fully understood by many lawyers, arbitrators and mediators. In fact, insurance information is generally not disclosable in securities arbitration, and is considered confidential information by many broker-dealers and insurance industry professionals. The overwhelming majority of securities arbitrations are litigated before the Financial Industry Regulatory Authority (FINRA). Yet the FINRA discovery guide does not require disclosure of insurance information in customer arbitrations, although a proposal has been floated which would make the respondent's insurance coverage potentially discoverable. This article will survey some common insurance issues in arbitration and mediation, including conflicts of interest.

Cumulating Claims

The existence and extent of insurance coverage is useful information for claimants' counsel and defense counsel alike, can significantly affect the outcome of mediation, and can sometimes even help claimant's counsel determine whether a claim is worth pursuing in the first place. While larger financial industry wire-houses tend to be largely self-insured, at least at most levels, most independent model broker-dealers have at least some form of errors and omissions insurance, which is typically subject to a self-insured retention.

Occasionally, in the case of smaller, independent model broker-dealers with small balance sheets, larger claims may prove to be uncollectable due to the erosion of policy limits or coverage limitations. Cumulating claims can have a tsunami effect, by which thinly-capitalized broker-dealers may not have the financial capacity to survive the exposure resulting from multiple cascading claims arising from a particular broker or product. For example, GunnAllen Financial, which was shuttered by FINRA in 2010 for insufficient capital, was overwhelmed by claims arising from a single registered representative, who sold approximately $74 million of investments to eight hundred investors in what turned out to be a Ponzi scheme. Other firms have been

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swamped by multiple claims arising from failed products.

Coverage Limitations

Claimant's counsel—and mediators—should be cognizant of potential insurance coverage limitations, which can also affect the ability to collect on an arbitration award at the conclusion of the case. For example, while individual insurance policies may have different terms, many policies exclude coverage for selling away claims, by which a registered representative sells unapproved products without the firm's knowledge. Since typically an insurance policy would contain an exclusion for selling away activity, such claims may be difficult to collect, particularly against an individual broker. In anticipation of such issues, claimants' lawyers routinely seek coverage by naming the broker-dealer and alleging a cause of action for failure to supervise, which may trigger coverage, depending on the policy terms. Other common exclusions might be for theft, churning, or repetitive buying and selling of the same securities positions in order to generate commissions for the broker, or charging excess commissions and fees.

Counsel should understand the limitations on errors and omissions insurance, and formulate their mediation strategy accordingly. Experienced claimants' counsel often anticipate the potential coverage aspects of the case, even in situations in which the policy itself may not be discoverable. For example, since fraud claims are generally excluded by most insurance policies, and uninsurable as a matter of public policy in many jurisdictions, claimants' counsel should know that a fraud-based mediation strategy is unlikely to gain much traction at a mediation with an insurance carrier. Claimants' counsel often attempt to steer their cases, both in pleadings and at hearing, away from claims likely to be uncovered, such as selling away and churning, and toward claims more likely to trigger coverage, such as supervision or suitability.

Attending Mediations

Another perennial issue is whether insurance claims professionals should personally attend securities mediations. As mentioned, insurance information is not generally discoverable in securities arbitrations. Most broker-dealers regard the existence of E & O insurance as confidential, and not to be disclosed to the claimants' bar, absent an explicit order by an arbitrator. A claims professional's presence at a securities mediation will obviously indicate the existence of insurance—and potentially raise the settlement price accordingly. Thus, the insurer's decision to attend a mediation should be carefully considered. In some circumstances, such as a series of multiple product arbitrations with sophisticated counsel, claimants' counsel may already be aware of the existence of insurance. Moreover, in most court cases, including federal court, insurance information is disclosable as a matter of course.

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In many circumstances, attendance at a mediation by the insurance claims professional may be prudent. For example, in a situation in which there is a reservation of rights in which some claims are covered and others are not covered, there may be a conflict of interest (discussed below) in which defense counsel may not be able effectively (or ethically) to advocate for an allocation between covered and uncovered claims. Thus, the claims professional may need to appear at the mediation to explain to the mediator and claimants' counsel that, for example, the selling away claims are not covered by insurance but the suitability claims are, or that a multi-million dollar fraud award may be uncollectable.

Ethical Issues

Counsel should be alert to potential professionalism concerns raised by the existence (or lack) of insurance. Ethical issues are raised for claimants' lawyers who represent multiple investors seeking recovery from a single limited pot. Imagine, for example, a claimant's counsel who represents three investors claiming aggregate losses of $2 million against an insurance policy which is only sufficient to pay out $1 million in claims. Depending on the availability of firm resources to fund an arbitration award, that lawyer might have a potential conflict of interest representing the multiple investors who are all seeking to feed at the same proverbial trough. In such instances, claimant's counsel would need to obtain a written agreement among the various clients to allocate the arbitration award or settlement proceeds or, in an extreme situation, might even need to withdraw from representing one or more of the multiple clients.

Conflicts of interest can also be caused on the defense side by the representation of multiple parties, such as both the broker-dealer and the registered representative. These conflicts may be due to different resolution objectives. Typically, the broker-dealer and insurance carrier are motivated to resolve the case based on a basic cost-benefit analysis (e.g., settling where the costs of litigating to conclusion would exceed the likely award), whereas the individual broker may seek to fight the case through hearing due to reputational concerns. Moreover, defense counsel may be beholden to the corporate client or the insurance carrier due to long-standing business relationships, whereas an individual broker may only be a one-off representation. Under those circumstances, counsel should consider whether the conflict is waivable under the rules of professional conduct, and if so, to obtain a written conflict waiver.

Additional Conflicts

Counsel for insured broker-dealers may have additional conflicts of interest. It is well-settled that assigned counsel for defense owe their primary duty to the insured policyholder, even in situations in which someone else, such as an insurance carrier, is paying the bill.

The duties of insurance defense counsel are set forth in New York Rules of Professional Conduct 1.8 and 5.4. According to RPC 1.8 (f);

> A lawyer shall not accept compensation for representing a client, or anything of value related to the lawyer's representation of the client, from one other than the client unless:
> 1. The client gives informed consent;
> 2. there is no interference with the lawyer's independent professional judgment or with the client-lawyer relationship; and
> 3. the client's confidential information is protected as required by Rule 1.6.

Similar duties are imposed by RPC 5.4(c).

Potential conflicts of interest may be raised by a reservation of rights letter in which a carrier agrees to cover some portions of the claim, but not others. For example, the claim could include both approved and unapproved products, of which only the former but not the latter are covered. Or the claim could include components of both churning, which is not covered generally, and suitability, which might well be covered. Depending on whether the insurability of the claim could be affected by how it is defended, and the individual policy language, potential conflicts could arise between the interests of the insurance carrier and the policy holder, placing defense counsel on the horns of a tripartite dilemma. However, in many cases, the fact that a portion of the claim is not covered cannot be changed by the way the claim is pled or defended (an uninsured product is not covered regardless of whether the claim is for negligence, fraud or failure to supervise).

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Under these circumstances, the courts in some (but not all) jurisdictions have held that an outcome-determinative reservation of rights letter creates a conflict which gives the insured a right to select counsel of its own choosing at the carrier's expense. See *Public Service Mutual Insurance Company v. Goldfarb*, 53 N.Y.2d 392 (1981) (insurer's reservation of rights gives rise to conflict of interest entitling insured to select independent counsel at carriers expense). In fact, some courts have ruled that an insurance carrier has an affirmative obligation to notify its insured of its right to independent counsel at the carrier's expense in the event of an outcome-determinative conflict of interest. See *Elacqua v. Physicians Reciprocal Insurers*, 52 A.D.3d 886 (3d Dept. 2008).

Conclusion

While presumptively not discoverable in arbitration, the existence and extent of errors & omission insurance can influence the resolution of a claim. Even in situations in which insurance information is unknown or incomplete, counsel and mediators often design their strategies respectively, in order to maximize the benefits to their prospective clients, and toward overall case resolution.