

## Disqualifying Counsel: A New SEC Enforcement Tactic?

*Law360, New York (August 17, 2010)* -- Amid the rebuilding of the U.S. Securities and Exchange Commission's enforcement program, a new trend may be emerging — interference by the enforcement staff with the relationship between witnesses and their counsel.

In a number of public speeches, senior division leadership has suggested that the SEC's new cooperation tools and the rewards that they provide to early cooperators will create conflicts for counsel representing multiple witnesses in the same investigation.

While there is nothing improper or necessarily incorrect about these statements, this emphasis runs the real risk of possible staff overreaching. Such a case of apparent overreaching was seen in the SEC's recent unsuccessful motion to disqualify defense counsel in the Morgan Asset Management administrative proceeding. See *Morgan Asset Management Inc. et al.*, Release No. 657/July 19, 2010.

Below, we discuss the recent staff statements and the Morgan Asset Management motion in more detail. As we explain, when faced with this problem, counsel and their clients should evaluate the existence of an actual or potential conflict of interest, deal with the conflict, and in most cases be able to resist the SEC's efforts to interfere with the clients' choice of counsel.



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### SEC Cooperation Initiative and Multiple Representations

On Jan. 13, 2010, Robert Khuzami, the SEC's director of enforcement, announced a new SEC cooperation program that he described as having "the potential to be a game changer for the Division of Enforcement."

Among the new tools available to witnesses who come forward and report wrongdoing are cooperation agreements, deferred prosecution agreements, and nonprosecution agreements. Timing is critical. As Mr. Khuzami explained, “Latecomers rarely will qualify for cooperation credit, so there is every reason for them to step forward before someone else does.” Robert Khuzami, News Conference on Strengthening SEC Enforcement Efforts, Jan. 13, 2010.

A few weeks prior to that speech, Mr. Khuzami addressed the impact of the cooperation initiative on the representation of multiple witnesses: “The broader availability of cooperation credit will increase the risk of conflicts of interest in situations where counsel seeks to represent multiple clients.”

Mr. Khuzami focused in particular on instances where one or more clients wish to be the first to report misconduct to the SEC or where it may be in the interest of one client to provide evidence that may harm another client.

Mr. Khuzami emphasized that “this new program could pose heightened ethical concerns for counsel representing more than one person who could potentially benefit from cooperating in a Commission investigation.” Robert Khuzami, Remarks at AICPA National Conference on Current SEC and PCAOB Developments, Dec. 8, 2009.

The SEC’s deputy director, Lorin Reisner, also warned counsel of the “obvious ethical issues” associated with multiple representations and the new cooperation initiative. Mr. Reisner indicated that SEC staff will closely evaluate situations where counsel represents more than one client. Compliance Reporter, “Beware Cooperation Conflicts, Attorneys Warned” (Feb. 12, 2010).

Viewed in isolation, there is nothing inherently wrong with these comments. However, the increased emphasis clearly sends a message to the defense bar and to the enforcement staff. A concern here is that aggressive staff action has the potential to chill the attorney-client relationship and become overreaching. The Morgan Asset Management case discussed below may present just such an overreach.

### **Morgan Asset Management**

On the heels of the message sent by senior division leadership, the SEC moved to disqualify defense counsel in an administrative proceeding against Morgan Keegan & Company, Morgan Asset Management, and two employees. They were accused of fraudulently overstating the value of securities in five funds that were backed by subprime mortgages. One law firm was acting as counsel to all four respondents. Previously, that firm had also represented numerous witnesses in the SEC’s investigation.

In support of its motion, the SEC alleged two conflicts. First, the staff cited the firm’s representation of all four respondents in the proceeding. The SEC claimed that the respondents had “potential defenses involving the conduct of [each] other, but they are foreclosed from any such blame-shifting” because counsel represented all respondents.

Second, the SEC argued that the firm would not be able to effectively cross-examine four additional individual witnesses without divulging privileged information learned during the law firm’s prior representation of the individuals during the staff’s investigation.

In a strongly worded opinion, the administrative law judge concluded that the SEC did not show that any actual conflicts of interest existed. Notably, the judge determined that granting the SEC’s motion would result in the SEC’s gain of “a significant tactical advantage.”

### **An Uphill Battle to Disqualify Opposing Counsel**

As demonstrated in Morgan Asset Management, any effort to disqualify opposing counsel — particularly when motivated by purely tactical concerns — is problematic. While there is no absolute right to counsel of one’s choosing, there is generally a very high bar placed on interference with the attorney-client relationship.

The “heightened ethical concerns” raised by Mr. Khuzami are not automatically triggered by multiple representations in matters pending before the SEC. In its enforcement manual, the SEC has recognized that the representation of multiple parties during the course of SEC investigations is not unusual. In fact, the SEC notes that “counsel is not precluded from representing more than one witness in the same investigation absent a showing that such representation will obstruct or impede the investigation.”

As further reinforced by the recent order in Morgan Asset Management, the SEC must, at a minimum, demonstrate that a legitimate, concurrent conflict of interest exists in order to successfully disqualify opposing counsel. Rule 1.7(a) of the Model Rules of Professional Conduct (“Model Rules”) states that a concurrent conflict 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.

Even if an actual conflict of interest exists, counsel may continue to represent multiple clients if:

- the lawyer reasonably believes that he or she will be able to provide competent and diligent representation to each affected client;
- the representation is not prohibited by law;
- the representation does not involve the assertion of a claim by one client against another in the same proceeding; and
- each affected client gives informed consent, confirmed in writing.

Conflicts of interest between current and former clients represented by the same counsel may provide a separate basis for disqualification.

An attorney is prohibited from representing a current client if the representation involves the same or a substantially related matter and the current client’s interests are materially adverse to the interests of the former client, unless the former client provides informed written consent.

However, even in the absence of the former client’s consent, Morgan Asset Management demonstrates that the SEC’s argument for disqualification may be deemed unpersuasive when the former client does not join in the motion to disqualify.

Finally, Morgan Asset Management is also instructive to the extent that it places SEC precedent into context by squaring the standard adopted in Clark T. Blizzard with the less stringent Model Rules.

In Blizzard, the SEC’s motion to disqualify opposing counsel was granted in a proceeding where counsel represented an individual respondent as well as individuals whom the SEC intended to call as witnesses at trial. See Clark T. Blizzard, 77 SEC Docket 1515 (Apr. 24, 2002). The commission stated that the consent of counsel’s clients could not address the “appearance of a lack of integrity” created by the multiple representations.

The SEC relied on Blizzard in support of its motion to disqualify in Morgan Asset Management. In particular, the SEC argued that the Model Rules conflicted with the more stringent standard adopted in Blizzard and should be

rejected. The SEC also maintained that, per *Blizzard*, counsel could not rely on written conflict of interest waivers signed by the respondents in order to avoid disqualification.

The judge rejected both arguments. Citing the commission's reliance on the Model Rules in post-*Blizzard* proceedings, the judge evaluated the SEC's first alleged conflict of interest in accordance with Model Rule 1.7. The judge further found that *Blizzard* did not set forth a "per se rule categorically rejecting all conflict-of-interest waivers involving potential conflicts of interest."

Accordingly, the Model Rules approach remains available to parties opposing a motion to disqualify, and client waivers continue to play an important role in the analysis of an alleged conflict of interest.

### **Protecting Against Inappropriate Interference With the Attorney-Client Relationship**

Defense counsel should be adequately prepared to face a challenge to clients' choice of counsel. There are steps that attorneys can take to ensure that counsel is not disqualified:

#### ***Step One***

Research applicable bar rules, ethical rules, case law, and any other binding precedent. The best way to quash inappropriate interference in the attorney-client relationship in its early stages is to be familiar with the relevant ethical rules and know the law governing conflicts of interests, particularly as they pertain to multiple representations.

During an investigation, a well-researched and thorough response to the SEC's suggestion of a conflict of interest should cause the staff to reconsider the strength of their position. As the investigation progresses, counsel will be more sensitive to what may give rise to potential conflicts and how such conflicts might be avoided.

#### ***Step Two***

Fully and immediately inform all affected clients of conflict issues, preferably in writing. Any waiver of an actual conflict of interest signed by an affected client must be the result of informed consent.

Therefore, it is important that counsel fully explain any actual or potential conflict issues to the client. SEC Form 1662 (Supplemental Information for Persons Requested to Supply Information Voluntarily or Directed to Supply Information Pursuant to a Commission Subpoena) may serve as a useful reference. Form 1662 states:

"You may be represented by counsel who also represents other

persons involved in the Commission's investigation. This multiple representation, however, presents a potential conflict of interest if one client's interests are or may be adverse to another's. If you are represented by counsel who also represents other persons involved in the investigation, the Commission will assume that you and counsel have discussed and resolved all issues concerning possible conflicts of interest. The choice of counsel, and the responsibility for that choice, is yours."

It might be advantageous to advise clients of the components of the new SEC cooperation initiative and how the availability of such incentives could present a potential conflict of interest.

#### ***Step Three***

In complex cases, consult ethics counsel. When a given case presents unique circumstances that are not readily resolved by a review of the ethical rules and binding precedent, it may be in the clients' best interest to seek the advice of a separate attorney who can advise them on whether to consent to the multiple representations and waive conflicts.

#### **Step Four**

Obtain client waivers, if necessary. According to the Model Rules, the waivers must be in writing and based upon informed consent.

#### **Step Five**

In a case where there are questions about a waiver or about the potential impact of multiple representations, consider engaging shadow counsel. Shadow counsel should be available to competently and diligently represent the affected client(s) in any aspect of the proceedings where representation by counsel of record would give rise to a conflict of interest.

#### **Step Six**

Be prepared to suggest to the SEC ways to prevent potential conflicts from becoming actual conflicts and ways to cure potential conflicts of interest short of disqualification.

The judge in Morgan Asset Management outlined the various ways that the SEC's alleged potential conflict could have been prevented or cured (i.e., substitution of witnesses, stipulation of the parties, or the engagement of new counsel to conduct cross-examinations of certain witnesses).

Even if the SEC is unwilling to agree to such work-arounds, the SEC's refusal to reasonably resolve the potential conflict might serve to further undermine its argument for disqualification.

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