CLIENT UPDATE

SECOND CIRCUIT DEFERS TO SEC IN OVERTURNING DISTRICT COURT'S REJECTION OF SETTLEMENT WITH "NEITHER ADMIT OR DENY" LANGUAGE

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On June 4, 2014, the United States Court of Appeals for the Second Circuit overturned a widely publicized Southern District of New York opinion by Judge Rakoff, holding that Judge Rakoff abused his discretion in requiring, as a condition of approving the settlement between the Securities and Exchange Commission ("SEC") and Citigroup Global Markets Inc. ("Citi"), that the SEC establish the "truth" of the allegations against Citi.[1] In rejecting the district court's analysis, which the Second Circuit previously had stayed,[2] the Second Circuit noted that settlements are "primarily about pragmatism" and provide parties with a "means to manage risk." The assessment of those risks, the Second Circuit held, is "uniquely for the litigants to make."

BACKGROUND

Although it has shifted policy recently to require admissions from settling defendants in some cases, the SEC historically has permitted defendants to enter into settlement agreements in which a settling party neither admits nor denies the SEC's allegations. For defendants, this approach has allowed them to settle disputes with

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1 *See S.E.C. v. Citigroup Global Mkts., Inc.*, No. 11-5227-cv (2d Cir. June 4, 2014).

2 *S.E.C. v. Citigroup Global Mkts., Inc.*, 673 F.3d 158 (2d Cir. 2012); *see also* Debevoise & Plimpton LLP, Client Update: Second Circuit Signals Support for the SEC's USE of "Neither Admit Nor Deny" Language in Consent Settlements," *available at* http://www.debevoise.com//clientupdate20120316b.

the SEC without incurring the stigma of an admission of wrongdoing or the collateral consequences that might arise in related shareholder or other litigation. For the SEC, the approach has allowed it to more easily resolve cases that might be difficult or resource intensive to bring to trial.[3]

Judge Rakoff's opinion in late 2011 threatened to disrupt this historic practice. In that case, the SEC sought the court's approval of its proposed settlement with Citi stemming from Citi's sales of mortgage-backed securities. In the proposed settlement, Citi would neither admit nor deny the SEC's claims, but would consent to a permanent injunction from future violations of certain provisions of the Securities Act and pay $285 million in disgorgement and penalties. Judge Rakoff rejected the settlement, finding that because Citi did not admit to any facts or wrongdoing in the settlement and the SEC had not proven them at trial, the court could not find that the proposed settlement was "fair, reasonable, adequate, and in the public interest"—the standard for approving settlements with injunctions.[4] Judge Rakoff also criticized the SEC for bringing only negligence-based fraud charges against Citi and faulted the entire SEC settlement process, which he wrote is frequently viewed in the business community "as a cost of doing business imposed by having to maintain a working relationship with a regulatory agency."[5] Following Judge Rakoff's lead, several other district courts from around the country scrutinized SEC consent decrees and challenged the agency to establish the adequacy of those settlements.

THE SECOND CIRCUIT'S OPINION

Both the SEC and Citi appealed Judge Rakoff's ruling, and after initially staying Judge Rakoff's decision in March 2012 pending a decision on the merits, the Second Circuit this week overturned Judge Rakoff's opinion and order, finding that "the district court had abused its discretion by applying an incorrect legal standard in assessing the consent decree."[6] The Second Circuit's opinion gives great deference to the SEC in the settlement process; however, the opinion acknowledges a role for the courts—and clarified the standard the district courts should use—when reviewing proposed settlements.

According to the Second Circuit, when a district court reviews a proposed SEC settlement, it must determine whether the proposed settlement is "fair and reasonable." The Second Circuit disagreed with Judge Rakoff's view that a court must assess the "adequacy" of the

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3 Recent trial losses for the SEC highlight the difficulty it faces bringing complex securities law cases to trial.

4 *S.E.C. v. Citigroup Global Mkts., Inc.*, 827 F. Supp. 2d 328, 331 (S.D.N.Y. 2011).

5 *Id.* at 333.

6 *S.E.C. v. Citigroup Global Mkts., Inc.*, No. 11-5227-cv, slip op. at 2 (2d Cir. June 4, 2014).

settlement before approving it, noting that unlike in a class action where a settlement usually precludes future claims, private litigants typically can still bring a private right of action after an SEC settlement.[7] The Second Circuit then clarified the correct standard courts should apply when evaluating if a proposed consent decree is "fair and reasonable," and added that the "primary focus of the inquiry. . . should be ensuring the consent decree is procedurally proper."[8] The Second Circuit also cautioned courts "not to infringe on the SEC's discretionary authority to settle on a particular set of terms."[9]

If a settlement includes injunctive relief, the district court must also find that "public interest would not be disserved" by approval of the settlement. Here again, in cases involving the SEC or other administrative agencies, the Second Circuit deferred to the judgment of the agency, noting that "the job of determining whether the proposed [settlement] best serves the public interest. . . rests squarely with the SEC."[10]

The Second Circuit rejected as "an abuse of discretion" Judge Rakoff's determination that the SEC be required to "establish the 'truth' of the allegations against a settling party as a condition for approving the [settlement]."[11] The Second Circuit noted that, while trials are "primarily about the truth," consent decrees are "primarily about pragmatism" and, as such, they provide parties with an important tool to "manage risk." The assessment of the risks of litigation, the Court observed, is "uniquely for the litigants to make." It is outside a court's "purview" to demand, as a condition for approving a consent decree, that the parties present "'cold, hard, solid facts, established either by admissions or by trials[.]'" Even where the SEC's 'case against defendants may be strong, the Court noted, there are risks with proceeding to trial for a resource-limited agency like the SEC which is why consent decrees often serve as an important enforcement tool.

In a concurring opinion, Judge Lohier stated that, in his view, the perceived modesty of any monetary penalty in a proposed consent decree should not be a reason for rejecting a settlement provided the "fair and reasonable" standard articulated by the majority was satisfied. In addition, Judge Lohier noted that the factual record before the district court was sufficient to satisfy the "fair and reasonable" standard, and therefore he was inclined to reverse and direct the district court to enter the consent decree.

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7 *Id.* at 19.

8 *Id.* at 21.

9 *Id.*

10 *Id.* at 24.

11 *Id.* at 21.

SETTLEMENTS GOING FORWARD

The Second Circuit decision gives deference to the SEC to shape its settlement agreements as the agency finds appropriate. The court acknowledged that in many instances, the *status quo ante* of allowing defendants to "neither admit nor deny" allegations will be sufficient.[12] The court also expressly stated there was "no basis in law for the district court to require an admission of liability as a condition for approving a settlement between the parties."[13] However, the court noted that, "[t]he decision to require an admission of liability before entering into a consent decree rests squarely with the S.E.C.," leaving open the possibility for the SEC to seek such an admission where it finds it appropriate.[14]

In June 2013, SEC Chair Mary Jo White announced a policy shift for the agency that, while perhaps not in direct response to Judge Rakoff's ruling, nevertheless mirrored the policy shift advocated by Judge Rakoff. Specifically, Chair White announced that the SEC would require in certain cases that defendants admit to wrongdoing or else face trial. Chair White explained that the agency would seek admissions, for example, in cases where a large number of investors have been harmed; where the conduct posed a significant risk to the markets; where admissions would aid investors in deciding whether to deal with a party in the future; and where it would send a message to the market.[15] Since the policy shift, the SEC has announced several settlements in which defendants admitted wrongdoing, and, according to recent comments by Director of Enforcement Andrew Ceresney, the agency has others in the pipeline.

Although the SEC seems poised to continue its pursuit of admissions in certain cases and to take more cases to trial if such admissions are not forthcoming, the agency's recent string of trial losses might serve to embolden defendants to reject the SEC's attempts to seek admissions and to take the agency to trial. It remains to be seen whether defendants who face the prospect of an admission or other onerous settlement terms that might not

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12 *Id.* at 22 ("[F]actual averments by the S.E.C., neither admitted nor denied by the wrongdoer, will suffice to allow the district court to conduct its review.").

13 *Id.* at 17.

14 *Id.*

15 Mary Jo White, Chair, SEC, Deploying the Full Enforcement Arsenal (Sept. 26, 2013), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370539841202.

differ materially from a negative trial outcome, will instead opt to litigate with the SEC rather than settle, especially if they believe they have a reasonable chance of success at trial.

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Please do not hesitate to contact us with any questions.

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