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Alert

# Has the Second Circuit Mandated a Rubber Stamp Approval System for SEC Consent Decrees?

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In a long awaited decision, the Second Circuit Court of Appeals has overruled United States District Court Judge Rakoff's refusal to affirm a $285 million settlement between Citigroup and the Securities and Exchange Commission ("SEC") and has clarified the scope of the court's review of SEC settlements. Although the Second Circuit decision is likely to curtail the recent trend of judicial activism as regards to SEC consent decrees, it does not mandate rubber stamp approvals of such settlements.

In a June 4, 2014 decision in United States Securities and Exchange Commission v. Citigroup Global Markets, Inc. (11-5227-cv (L)), the Second Circuit held the district court abused its discretion when it refused to approve the Citigroup consent decree and did not defer to the SEC's authority to resolve enforcement actions.

The Citigroup settlement at issue was intended to resolve a four year investigation and an SEC fraud suit against Citigroup. The SEC's suit, filed in the Southern District of New York, alleged that in 2007 Citigroup misrepresented to investors the attractiveness of certain mortgage-backed securities it placed in a specially created fund while simultaneously taking short positions in the same securities. As a result, Citigroup realized net profits of over $160 million on these investments, while the investors in the fund lost over $700 million. The settlement with the SEC required Citigroup to disgorge the $160 million in profits and to pay a civil penalty of $95 million. The settlement also required Citigroup to implement internal accounting and oversight control measures for three years to prevent recurrence of the same securities fraud. The Consent Judgment filed with the district court recited that Citigroup consented to the entry of the judgment "[w]ithout admitting or denying the allegations of the complaint." Following submission of the Consent Judgment and the form of settlement, the district court posed additional questions to the parties regarding the terms of the settlement.

In a November 28, 2011 Opinion, District Judge Rakoff refused to approve the Citigroup settlement "because the Court has not been provided with any proven or admitted facts upon which to exercise

even a modest degree of independent judgment." U.S. Securities and Exchange Commission v. Citigroup Global Markets, Inc., 827 F. Supp. 2d 328, 330 (S.D.N.Y. Nov. 28, 2011). The Court held that unlike settlements involving only private parties, settlements with agencies of the U.S. government that include injunctive relief must be approved by the Court to determine if they are fair, reasonable, adequate, and in the public interest. Id. at 331. The District Court squarely rejected the SEC's argument that the Court need not consider whether the settlement was in the public interest as contrary to established Supreme Court and Second Circuit precedent. Id. To approve such settlements, Judge Rakoff opined that the Court must be provided with the underlying facts supporting the settlement, "for otherwise, the court becomes a mere handmaiden to a settlement privately negotiated on the basis of unknown facts, while the public is deprived of ever knowing the truth in a matter of obvious public importance." Id. at 332.

Judge Rakoff criticized the SEC's long standing policy of allowing Consent Judgments absent an admission of liability, and likened that practice to a policy that "deprives the Court of even the most minimal assurance that the substantial injunctive relief it is being asked to impose has any basis in fact." Id. The District Court also criticized the proposed settlement as it did not require Citigroup to admit or deny the allegations and that it thus had no evidentiary value and would not work as collateral estoppel to Citigroup's ability to deny similar allegations in investors' suits to recover their losses. Id. at 334. The District Court surmised that all the SEC was getting from the settlement was a "quick headline." Even giving the traditional deference to the SEC's views on the settlement,

Judge Rakoff stated that without "any proven or acknowledged facts whatsoever" the Court could not find the settlement to be reasonable, fair, adequate or in the public interest. Id. at 335. But it is Judge Rakoff's final comments in Citigroup that sparked a renewed judicial scrutiny of settlements with the SEC and other government agencies: Finally, in any case like this that touches on the transparency of financial markets whose gyrations have so depressed our economy and debilitated our lives, there is an overriding public interest in knowing the truth. In much of the world, propaganda reigns, and truth is confined to secretive, fearful whispers. Even in our nation, apologists for suppressing or obscuring the truth may always be found. But the S.E.C., of all agencies, has a duty, inherent in its statutory mission, to see that the truth emerges; and if it fails to do so, this Court must not, in the name of deference or convenience, grant judicial enforcement to the agency's contrivances. [Id. at 335.] On appeal, the Second Circuit held that the District Court applied the wrong standard when it inquired whether the settlement was "fair, reasonable, adequate and in the public interest."

Although the Second Circuit did not mandate rubber stamp approval of SEC settlements of enforcement actions, the Second Circuit found that it was inappropriate for the District Court to inquire whether the settlement was "adequate." Instead, the Second Circuit held that the standard must be "whether the proposed consent decree is fair and reasonable, with the additional requirement that the 'public interest would not be disserved,' in the event that the consent decree includes injunctive relief." This fairness and reasonableness standard requires the court to assess "(1) the basic legality of the decree…; (2) whether the terms of the decree, including its enforcement

mechanism, are clear…; (3) whether the consent decree reflects a resolution of the actual claims in the complaint; and (4) whether the consent decree is tainted by improper collusion or corruption of some kind." Following from the reasoning of the Second Circuit, a court asked to approve a settlement with a government agency like the SEC must focus on the whether the consent decree is procedurally proper and should not "infringe on the SEC's discretionary authority to settle on a particular set of terms."

The Second Circuit recognized that one of the benefits of consent decrees is to allow both sites to manage risk and avoid the costs of litigation. To that end, it held that it was improper for the district court to require the SEC to establish the truth of the allegations by "cold, hard, solid facts, established either by admissions or by trials." The Citigroup decree included a permanent injunction barring Citigroup from violating the Securities Exchange Act Sections 17(a)(2) and (3); and requiring Citigroup to implement internal changes for three years to prevent similar acts in the future. Courts considering consent decrees including injunctive relief must also consider the public interest in approving the injunction. Citing to the U.S. Supreme Court's decision in eBay, Inc. v. MercExchange, 547 U.S. 388, 391 (2006), the Second Circuit held that a court must determine whether the parties have shown "(1) that [the party seeking injunctive relief] has suffered an irreparable injury; (2) that remedies available at law, such as monetary damages, are inadequate to compensate for that injury; (3) that, considering the balance of hardships between the plaintiff and defendant, a remedy in equity is warranted; and (4) that the public interest would not be disserved by a permanent injunction."

In the wake of Judge Rakoff's 2011 decision, courts began to take a harder look at SEC consent decrees. Insurers were closely watching these cases as this heightened scrutiny created the potential for development of facts supporting coverage defenses that would not exist under consent decrees that did not include admission of liability provisions. Additionally, in June 2013, the SEC instituted a new policy of requiring companies to accept liability in certain categories of cases. Most settlements would continue to include the no-admit format, but according to SEC Chairman Mary Jo White, admissions of liability may be required in cases involving "egregious conduct, where large numbers of investors were harmed, where the markets or investors were placed at significant risk, where the wrongdoer poses a particular future threat to investor or the markets, or where the defendant engaged in unlawful obstruction of the Commission's processes."

Now that the Second Circuit has clarified the standard for approval of consent decrees, we expect a likely return to consent decrees that neither admit nor deny the SEC's allegations except in cases involving the expanded categories as outlined in the SEC's June 2013 policy. The Second Circuit's decision in Citigroup returns substantial control over the terms of consent decrees to the broad discretion of the government agency. Please contact us with any questions you may have regarding this decision.