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Second Circuit Stays Challenge to SEC's Settlement Policy

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On March 15, a panel of the 2nd U.S. Circuit Court of Appeals granted a stay of the district court litigation brought by the Securities and Exchange Commission against Citigroup Global Markets Inc. The district court had rejected a settlement and consent judgment agreed upon by the parties in a decision that threatens to disrupt the SEC's long-standing policy of settling cases without demanding an admission of wrongdoing.

The decision stems from litigation filed by the SEC against Citigroup alleging the company knew in early 2007 that the bottom was falling out of the market for mortgage-backed securities (in which it was heavily invested) and housed those assets within a new billion-dollar fund, which it positioned as an attractive investment option, rigorously vetted and selected by an independent investment adviser. By doing so, Citigroup was able to offload much of its toxic mortgage-backed securities at a premium. By the SEC's measure, Citigroup netted $160 million in profit while the investors in the fund lost $700 million.

In October 2011, the SEC sued Citigroup for negligence in federal court in the Southern District of New York. At the same time, the SEC filed suit against an individual Citigroup employee, alleging that Citigroup knew that it would be difficult, if not impossible, to offload the mortgage-backed securities as part of a bundled fund if it disclosed the negative projections for those securities. Though the case against the individual included specific allegations that Citigroup acted with fraudulent intent, the SEC omitted those allegations from its complaint against Citigroup.

At the same time that the SEC filed suit against Citigroup, it submitted to the court a consent judgment, which was, in effect, a settlement of the SEC's negligence charges against the company. Under the terms of the proposed settlement, Citigroup consented to an injunction prohibiting it from future violations of Sections

17(a)(2) and (3) of the Securities Act and was required to implement internal measures to prevent the kind of negligence alleged in the complaint from happening again. Citigroup also agreed to turn over its $160 million in profit to the SEC (plus $30 million in interest) and to pay a civil fine of $95 million.

In a practice long adhered to by many federal agencies, the settlement included language that Citigroup was agreeing to the consent judgment "without admitting or denying the allegations of the complaint." Though the SEC does not permit companies to settle while denying all wrongdoing, it has typically allowed companies to settle without admitting violations.

The SEC has followed this practice for decades with the justification that it promotes quicker settlements and allows the agency to focus its resources on preventing and correcting other fraudulent activities. Citigroup was, of course, eager to settle the case without admitting wrongdoing, because, by doing so, the company could avoid a finding of liability that would have collateral estoppel effect. Such a finding would have made it much easier for fund investors to sue Citigroup, because Citigroup would be estopped from denying that it violated the law.

'Hallowed by History, but Not By Reason'

Both Citigroup and the SEC undoubtedly expected the settlement to be summarily approved by the Southern District of New York. Judge Jed S. Rakoff, who has often criticized SEC settlements in the past, had other ideas. After Rakoff issued an order requiring both parties to answer questions concerning the settlement in writing and held oral argument, he determined that he could not approve the settlement.

In rejecting the settlement, Rakoff applied a standard that required the court, before approving the settlement, to determine whether the agreement was "fair, reasonable, adequate and in the public interest." According to Rakoff, protecting the public interest was an important concern in settlements of this type:

"Purely private parties can settle a case without ever agreeing on the facts, for all that is required is that a plaintiff dismiss his complaint. But when a public agency asks a court to become its partner in enforcement by imposing wide-ranging injunctive remedies on a defendant, enforced by the formidable judicial power of contempt, the court, and the public, need some knowledge of what the underlying facts are: 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."

Rakoff expressed serious misgivings about "the SEC's long-standing policy — hallowed by history but not by reason — of allowing defendants to enter into Consent Judgments without admitting or denying the underlying allegations." Because the consent judgment would permit Citigroup to settle the case without admitting wrongdoing, Rakoff noted that the defrauded investors would be left without a finding that Citigroup violated the law. Furthermore, Rakoff noted that "Citigroup was able, without admitting anything, to negotiate a settlement that (a) charges it only with negligence, (b) results in a very modest penalty, (c) imposes the kind of injunctive relief that Citigroup (a recidivist) knew that the SEC had not sought to enforce against any financial institution for at least the last 10 years, and (d) imposes relatively inexpensive prophylactic measures for the next three years." In sum, "if the allegations of the complaint are true, this is a very good deal for Citigroup; and, even if they are untrue, it is a mild and modest cost of doing business."

Rakoff closed with some harsh words for the SEC, which he viewed as gaining nothing from the settlement but a "quick headline": "But the SEC, of all agencies, has a duty, inherent in its statutory mission, to see that the truth emerges; and if fails to do so, this court must not, in the name of deference or convenience, grant judicial enforcement to the agency's contrivances." Consequently, Rakoff found that the settlement was "neither fair, nor reasonable, nor adequate, nor in the public interest" and set a date for trial.

The Appeal and Stay

Citigroup, now staring at a trial, and the SEC, faced with the rejection of its decade-old settlement practices, jointly appealed Rakoff's rejection of the settlement, petitioned for mandamus relief and moved for a stay of the district court proceedings pending a decision on the merits. Notably, Rakoff, whom the parties had also

petitioned for a stay, strongly disagreed with the parties' position and questioned the legal basis for the parties to appeal his decision.

On March 15, a panel of the 2nd Circuit granted the parties' request for a stay. In considering the request, the panel considered whether the parties had shown a likelihood of success on the merits and whether a stay would prevent irreparable harm or injure other parties or the public. Though the 2nd Circuit quickly found that the application for stay met the latter prongs, its decision was notable for its finding that the parties had shown a substantial likelihood of success in overturning Rakoff's decision rejecting the settlement.

First, the panel disagreed with Rakoff that the settlement failed to serve the public interest. According to the panel, Rakoff erroneously assumed that the SEC could easily establish liability against Citigroup but instead chose to settle for no good reason. Further, the panel determined that Rakoff had failed to give deference to the SEC's own determination that the settlement was in the public interest, noting that while the SEC believed the $285 million settlement was in the public interest, Rakoff "simply disagreed."

Second, the panel took issue with Rakoff's determination that Citigroup should not be permitted to settle without admitting liability. Such a requirement would, according to the panel, undermine most chances for compromise.

Third, the panel viewed Rakoff's decision that an agency settlement could not be approved unless wrongdoing was specifically admitted or denied as tantamount to a ruling that a court could not approve an agency settlement representing a compromise.

Though the panel's decision merely stays the district court litigation while the merits appeal is pending, the panel's discussion certainly indicates that Rakoff may be ordered to approve the settlement.

Lessons

Certainly, any corporate entity that is subject to suit by a federal agency can breathe a bit easier after the 2nd Circuit panel's order. The prospect of being forced to admit wrongdoing before settlement can proceed is troubling to any company. However, even if the 2nd Circuit ultimately reverses Rakoff, the impact of his initial rejection of the settlement may still cause problems for companies looking to resolve agency lawsuits quickly and without collateral estoppel effect. More courts may follow in Rakoff's footsteps in more deeply reviewing settlements, rather than simply rubberstamping the agency's determination.

Corporate counsel would be wise to pay careful attention to the language used in crafting settlement agreements and consent judgments with federal agencies. If facts can be acknowledged and either admitted or denied without an admission of wrongdoing or impacting the company's underlying liability, the chances that a federal court will approve the settlement will likely increase.

Unless and until the 2nd Circuit reverses on the merits, the SEC's settlement policy remains in limbo. If the 2nd Circuit affirms Rakoff's decision, expect to see the SEC shift from use of federal courts to administrative actions as a way of policing its territory. •

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