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SEC ENFORCEMENT

Chinks in the Enforcement Armor: Recent Decisions Erode SEC's Favored Remedies

BY MARY O'CONNOR AND PATRICK O'BRIEN

The SEC's Division of Enforcement has been aggressively pursuing investigations and bringing charges in the last several years. Public companies and their officers and directors under investigation often find themselves in situations where there is no ''ill-gotten gain'' to be disgorged, turning the focus to injunctive relief, officer and director bar orders, and civil penalties. The impact of these remedies alone can be significant. During the past six months, however, several courts have rejected these cornerstones of the SEC's enforcement arsenal in situations that may provide leverage to companies and their directors and officers looking to exit an investigation or enforcement action on favorable terms. This article will analyze the impact of three of these decisions on defense and settlement strategies.

'Obey the Law' Injunctions

In *SEC v. Goble*, 682 F.3d 934 (11th Cir. 2012), the United States Court of Appeals for the Eleventh Circuit vacated a broad injunction requiring the founder of North American Clearing, Inc. to comply with specified provisions of the securities laws. Such ''obey the law'' injunctions have long been a favored remedy of the SEC.

Mary O'Connor is a partner and Patrick O'Brien is a counsel in the Dallas office of Akin Gump Strauss Hauer & Feld LLP, focusing on representing public companies, officers,and directors in securities litigation and SEC investigations.

The underlying case involved charges against North American, a securities and clearing brokerage firm that ran into financial difficulties in 2008, and three of its executives who caused North American to book a sham transaction to free up operating funds. After FINRA examiners quickly discovered the issue, the transaction was reversed and North American was forced to wind down its affairs. The SEC filed charges within days.

Goble, the only defendant to go to trial, had no official regulatory or supervisory responsibilities at North American but was an active participant in its day-to-day operations, sat on the board of directors, and in effect controlled a 100 percent interest in the company. The court found that Goble directed the company's CFO to record the sham transaction and subsequently signed a wire request to transfer funds out of North American's reserve account. On these facts, Goble was held guilty of aiding and abetting North American's violations of the antifraud provisions of Section 10(b) of the Exchange Act and Rule 10b-5, the Customer Protection Rule of Section 15(c)(3) of the Securities Exchange Act of 1934, and certain books and records requirements of Section 17(a) of the Exchange Act. The district court entered an injunction permanently restraining Goble from violating each of the charged provisions of the Exchange Act. Of its own accord, the district court also permanently enjoined Goble from obtaining a securities license or engaging in the securities business (the ''bar order'').

On appeal, the Eleventh Circuit found Goble's conduct did not violate Section 10(b) or Rule 10b-5, but upheld the district court's findings of violations of the books and records and Customer Protection provisions. The court of appeals found further that Goble should have an opportunity to respond to whether the bar order was appropriate based only on the remaining aiding and abetting violations.

The Eleventh Circuit then addressed the language of the injunctions, which it characterized as ''obey the

law'' injunctions that do little more than order the defendant to not violate specific statutes. Invoking its previous decision in *SEC v. Smyth,* 420 F.3d 1225, 1233 n.14 (11th Cir. 2005), the appeals court expounded on its view that such injunctions do not comply with the requirements of Rule 65 of the Federal Rules of Civil Procedure. Rule 65(d)(1) requires that an injunction: ''(A) state the reasons why it issued; (B) state its terms specifically; and (C) describe in reasonable detail – and not by referring to the complaint or other document – the act or acts restrained or required.''

Acknowledging that some statutes may provide the degree of specificity required by Rule 65 so that an injunction setting forth the requirements of the statute and providing ''specific, objective criteria for compliance'' may be proper, the Eleventh Circuit found that others—specifically, Section 10(b) of the Exchange Act and Rule 10b-5—do not. *Goble*, 682 F.3d at 951. ''Indeed, [a] defendant would need to review hundreds of pages of the Federal Reporters, law reviews, and treatises before he could begin to grasp the conduct proscribed by § 10(b) and in turn the injunction.'' *Id.* at 950.

The appeals court remanded to the district court to consider the appropriateness of the bar order and to draft an injunction addressing compliance with the Customer Protection Rule and books and records violations ''that allows Goble to understand his obligations under the injunction.'' *Id.* at 953.

Civil Penalties for Stale Claims

In another recent decision limiting the scope of the SEC's remedies, the United States Court of Appeals for the Fifth Circuit in *SEC v. Bartek*, No. 11-10594, 2012 WL 3205446 BL 199089 (5th Cir. Aug. 7, 2012), affirmed a summary judgment in favor of two executives charged with violating anti-fraud and books and records provisions of the securities laws, finding that the five-year statute of limitations had run on the SEC's claims for civil penalties. Along with broad injunctive relief, civil penalties are a central part of the SEC's enforcement arsenal.

The SEC alleged in *Bartek* that Microtune, Inc., former CEO Douglas Bartek, and former CFO and General Counsel, Nancy Richardson, improperly backdated stock options granted to newly-hired and existing employees and executives between 2000 and 2003. The alleged backdating scheme resulted in Microtune's failure to record and report $22.5 million of gross compensation expenses, resulting in materially misstated SEC filings.

Although Microtune (which had previously agreed to a cease and desist order in July 2005 to settle charges involving a revenue inflation scheme) settled the backdating charges when they were filed in 2008, Bartek and Richardson did not. The officers urged on summary judgment that the backdating practice occurred more than five years before suit was filed on June 30, 2008, and that the SEC's claims were therefore barred under the limitations period set out in 28 U.S.C. § 2462. The district court accepted the defendants' argument and found that the SEC's claims accrued when the violation occurred, rejecting the SEC's argument that the discovery rule applied and the violation could not have been discovered more than five years before suit. *SEC v. Microtune, Inc.*, 783 F. Supp. 2d 867, 881-83 (N.D. Tex. 2011). On appeal, the Fifth Circuit agreed with the district court's ruling and held that a plain reading of the statute shows that no discovery rule exception applied to the SEC's claims, invoking its rulings in other cases (not involving the securities laws) rejecting application of a discovery rule under § 2462.

Having found that civil penalties were time-barred under § 2462, the Fifth Circuit went on to consider whether the SEC's claims for an officer and director bar (O&D bar) and injunctive relief were also time-barred. The district court had found that these remedies, along with reimbursement of incentive compensation and trading profits under Section 304 of the Sarbanes-Oxley Act, are construed as penalties as a matter of law and would also be time-barred. The Fifth Circuit agreed, without discussing the Section 304 claim, holding that permanent injunctions and O&D bars could have a stigmatizing effect and long-lasting repercussions to the individual defendants. Neither the O&D bar nor the injunction was found to address past harm allegedly caused by the executives, or to address the prevention of future harm because there was a low likelihood that the executives would engage in similar conduct in the future.

An almost identical result was reached in a recent district court ruling in *SEC v. Fisher*, No. 07-C-4483, 2012 WL 3757375 BL 221345 (N.D. Ill. Aug. 28, 2012), granting summary judgment on statute of limitations grounds to two former executives of Nicor, Inc., from whom the SEC sought civil penalties, O&D bar orders, and injunctive relief. The executives, a former CFO and VP Administration, were charged with participating in an accounting scheme during 1999-2002 resulting in Nicor issuing restatements in March 2003. The SEC's complaint was filed on February 25, 2008. The court dismissed all civil penalties claims as time-barred under § 2462.

The court found in *Fisher* that the SEC had produced insufficient evidence to support the entry of injunctive relief or an O&D bar. The court noted that it had been more than four years since the SEC had initially stated that ''unless restrained and enjoined by this Court'' the executives would continue to engage in conduct that violates the securities laws, and nearly ten years since the conduct ended and the SEC's investigation began. It further noted that the former VP Administration was now employed by a private company and there was no evidence he had engaged in comparable misconduct before or since the Nicor fraud. The former CFO was now retired and did not plan to begin working again. The SEC failed to bring forward any evidence of the gravity of the harm or the executives' economic stake in the scheme. Following summary judgment, the *Fisher* case continues solely for determination of whether the executives should be required to disgorge any ''ill gotten gains.''

Considerations for Strategy

These rulings strike at the heart of some of the SEC's most frequently used remedies in enforcement actions. Even in matters where the conduct under investigation did not yield any ''ill gotten gains'' to the individuals or corporations involved, the SEC may seek injunctive relief, O&D bars, and civil penalties. These remedies, together with the prospect of years of stress and steep attorney's fees to fight an SEC enforcement charge, are potent weapons in the SEC's arsenal. For public compa-

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nies, which are understandably reluctant to litigate with the SEC, and their executives, who have become less reluctant to do so as the stakes have grown, the rulings offer some guidance in developing defense strategies and perhaps some small prospect of leverage in the right circumstances.

Stale claims should be analyzed carefully. Popular wisdom holds that there is always a way for the SEC to craft a claim that beats the statute of limitations. The *Bartek* case suggests otherwise. Consequently, companies and executives under investigation for activity that occurred several years in the past should pay careful attention to identifying conduct that may give rise to a disgorgement claim (which is not subject to the five-year statute of limitations under § 2642) versus conduct that is unlikely to give rise to disgorgement. Where there is no disgorgement claim, subjects of investigation and defendants may have an effective argument that other remedies are time-barred and unavailable.

There are, of course, limits to the usefulness of the *Bartek* decision. Right now the Fifth Circuit's position in *Bartek* that no discovery period applies to SEC enforcement claims for civil penalties is at odds with a recent Second Circuit case (and rulings of at least three other courts of appeals).

The Supreme Court recently granted certiorari to consider the Second Circuit's decision in *SEC v. Gabelli*, 653 F.3d 49 (2d Cir. 2011), which held that the five-year statute of limitations under § 2642 does not begin to run as to a claim that sounds in fraud until the SEC discovers or should have discovered the fraud.

SEC enforcement staff and litigation counsel may be hesitant to make concessions on the basis of *Bartek*, hoping for a more favorable ruling in *Gabelli*. Timing is key, however. Many financial crisis cases involve conduct occurring on or before the second quarter of 2008, five years before a ruling can be expected from the Supreme Court.

If the Supreme Court sides with the Fifth Circuit's bright line rule in *Bartek*, then civil penalties in those cases will be barred, at least by early 2013, regardless of when the SEC began investigating. Indeed, many of the SEC's enforcement tools, including injunctive relief and O&D bar orders, will lose any value for that conduct. In addition, the possibility of obtaining Section 304 reimbursement from executives whose companies restated earnings before mid-2008 may also be lost, following the district court's summary judgment order in *Bartek* finding that such reimbursement claims were akin to penalties and therefore subject to the five-year statute of limitations. Thus the SEC faces significant pressure in coming months to resolve matters involving conduct before mid-2008, opening opportunities to discuss whether charges are worth pursuing at all as well as opportunities for favorable settlement based on limitations issues.

Not all investigations involve stale claims, however. In those matters, the *Goble* decision should inform consideration of whether to agree to standard SEC language for injunctions. ''Obey the law'' injunctions are often viewed as a handy tool for both targets and enforcement staff to resolve a matter. The language of the injunction itself (as opposed to the findings that accompany it) is so formulaic that agreeing to such language appears to be a simple way to resolve an enforcement matter.

Parties looking to resolve an enforcement matter should carefully consider the consequences of the standard ''obey the law'' verbiage of SEC injunctions and attempt to narrow broad antifraud language. For starters, the SEC's standard language has a significant multiplier effect. Violating a C&D order can cause the offender to be designated a ''recidivist.'' This in turn is likely to prompt a civil penalty (where none may have been imposed at the time of the C&D order) or an increased penalty amount over the first violation. Further, the violation of the C&D order is also likely to result in imposition of an injunction with similarly broad ''obey the law'' language. A future violation of this broad injunction, no matter how many years later, can then form the basis for contempt and even stiffer penalties.

Limiting the scope of the injunction can also minimize risk of future violation. The *Goble* decision, while limited in application to the Eleventh Circuit, suggests the difficulty of compliance with an ''obey the law'' injunction in the 10b-5 context. For public companies with far-flung operations, this can be especially problematic. A more narrowly tailored order, identifying specific prohibited acts, may avoid an unwarranted multiplier by facilitating compliance. The language of such an order, precisely because it would be tailored to the infraction, may be viewed differently in the marketplace than the standard ''obey the law'' wording that has issued in many previous enforcement actions. Finally, while some commentators have suggested that the vulnerability of ''obey the law'' injunctions may give the SEC pause in seeking contempt sanctions, courts may be willing to enforce the injunction if it was part of an agreed settlement. Thus, in considering whether to push for a more specific order, companies and executives should consider the potential risks and benefits of varying from the broad form language.

Finally, individual executives evaluating settlement in an enforcement action should consider the long term. Individual executives who become subject to injunctions and O&D bars sometimes are able to modify or lift those restrictions in later years. Tighter focus on limiting the terms of the injunction and O&D bar may prove helpful in future efforts to lift the order after time has passed with no recurrence of the sanctioned conduct.