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PERSPECTIVE

Some prefer litigation when the SEC calls

By Michael Mugmon and Chris Johnstone

Securities and Exchange Commission Chair Mary Jo White's commitment to enforce securities violations like a cop on the beat seems certain to lead to more litigation, requiring a vigorous defense from the outset for individuals and companies faced with an SEC investigation.

White has said she's adopting the "broken windows" policy of policing that New York City Police Commissioner William J. Bratton adopted in the 1990s to crack down on small infractions to prevent large ones. As she described it, minor security violations that are "overlooked or ignored can feed bigger ones," so she pledged to "pursue even the smallest infractions."

White and other top SEC enforcement officials have also made clear that the SEC will use the threat of litigation and large fines as weapons to force settlements and admissions that can put clients at greater risk of shareholder lawsuits and other costly litigation. In many cases, clients will find the agency's settlement demands are unacceptable and instead will conclude that litigation is their best option for many reasons, including the following four:

First, the SEC has announced that it will not always pursue its customary "no-admit, no-deny" settlements. Instead, the agency may seek admissions of wrongdoing in circumstances where: (1) a large number of investors have been harmed or the conduct was egregious; (2) the conduct posed a significant risk to the market or investors; (3) admissions would aid investors in deciding whether to deal with a particular party in the future; or (4) reciting unambiguous facts would send an important message to the market about a particular case.

Since this policy change in June 2013, the SEC has secured admissions in six cases. Such admissions have the potential to be enormously damaging in parallel proceedings. Under principles of collateral estoppel, the admission of liability in an SEC case could provide tremendous leverage to plaintiffs in related shareholder class actions or derivative lawsuits involving similar underlying facts.

Providing an admission in an SEC settlement could have the unwanted effect of compounding the overall regulatory burden. Indeed, it would not be surprising to see other agencies at the state or federal level seize upon an admission in a settlement with the SEC to build their own cases against a defendant. The adverse and unpredictable consequences of an admission will mean many clients will be forced to choose litigation over settlement.

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The SEC's pursuit of admissions also may push some clients toward litigation as a means of preserving their insurance coverage. In most circumstances, the costs of defending an SEC enforcement action are covered by insurance and, indeed, are advanced to the litigant. This means reasonable legal costs are paid up front and assumed by the insurer unless there is a finding (or an admission) of misconduct. Because many policies contain provisions allowing the insurer to recoup defense costs upon a finding of fraud, the SEC's demands for admissions could trigger this type of recoupment and thus may leave certain defendants with no viable option but to fight the SEC's charges in court.

Although SEC Enforcement Director Andrew Ceresney has indicated that admissions may be the exception rather than the rule, individuals and companies should be mindful of this possibility as they enter an investigation.

Second, the SEC has stated that it wants the penalties it imposes to have teeth. Ceresney has said that "monetary penalties speak very loudly and in a language any potential defendant understands." He further expressed the view that individuals need to "feel the pain of our remedies." Not only does the SEC regularly demand as the price of settlement what seem to be the outer limits of the maximum penalties available under current law, the agency is now supporting legislation that would permit even higher monetary penalties based on either three times the pecuniary gain or the amount of investor losses — whichever is greater.

As the cost of entering into a settlement — which, for individuals, often includes financially devastating penalties and multi-year bars to gainful employment — continues to escalate, many clients will be left with no real choice but to defend themselves in court.

Third, the subject of an SEC investigation may want to use the litigation process to get a basic understanding of the strength or weakness of the SEC's case. During the investigation phase, the SEC has a significant informational advantage based on its ability to subpoena documents and testimony. Of course, the subject of an investigation has no such powers, and often does not have a full understanding of the basis for the SEC's claims and contentions until litigation begins and the SEC is subject to discovery under either the Federal Rules of Civil Procedure or the Rules of Practice applicable to administrative proceedings.

The settlement dynamic may also improve over time. For example, certain claims could be dismissed or discovery could reveal a lack of support for the SEC's factual allegations. Some targets of SEC investigations, measuring the costs of early settlement, may now want to proceed to litigation with the goal of attempting to narrow the issues or expose problems with the SEC's theory of the case. Even in the event of a liability finding at trial, the court may impose significantly less onerous penalties and prospective relief at the remedies stage than the SEC demanded in settlement negotiations.

Fourth, the recent losses at trial, combined with the publicity those cases have received, have fed the perception that the SEC is not always ready to prove its cases in the courtroom. Despite the inherent advantage of proceeding as a government agency enforcing the rule of law, the SEC has not always prevailed in proving the elements of securities fraud to a jury.

This is especially true where the case involves complex financial transactions, subjective accounting judgments or collective conduct. Although some of these defeats have come in the most challenging cases for the SEC (those tend to be the ones that reach the courtroom without settling), they have also occurred where the agency appears to be overreaching in its theories, its evaluation of the evidence, its demands for relief — or all of the above.

THE CUTTING EDGE

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As White has conceded, "proving intent inside the courtroom in white-collar cases is always a difficult challenge" because the SEC usually must proceed "without the benefit of cooperators, wiretaps, surveillance evidence, and many of the other tools at the disposal of [criminal] prosecutors."

Although the SEC has touted an 80 percent success rate at trial over the past three years, we believe this figure is substantially lower when limited to complex cases. The SEC's success rate is all but certain to decline if the agency attempts to try more cases similar to those in which the recent losses have occurred.

Michael Mugmon *is a partner in the Palo Alto office of the WilmerHale law firm and one of the Daily Journal's "Top 20 Under 40." He is a member of the firm's Litigation Department and its Securities Department. Mr. Mugmon may be reached at (650) 858-6103 or Michael.Mugmon@WilmerHale.com.*

Chris Johnstone *is counsel in the Palo Alto office of the WilmerHale law firm experienced in complex securities litigation and the defense of government enforcement actions. He is a member of the firm's Litigation Department and its Securities Department. Mr. Johnstone may be reached at (650) 858-6147 or Chris.Johnstone@WilmerHale.com.*


MICHAEL MUGMON
WilmerHale


CHRIS JOHNSTONE
WilmerHale