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String of Recent Circuit Court Opinions Impact SEC Enforcement Program

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The authors examine four recent federal circuit court decisions that they believe have the potential to influence litigated matters involving SEC investigations that are currently pending before federal courts, and that may well have an impact even at the investigative stage.

Four federal circuit courts recently issued a string of rulings that are likely to have an impact on the manner in which the Securities and Exchange Commission ("SEC") seeks to police the financial markets and penalize alleged misconduct. The Courts of Appeals for the Second, Fifth, Ninth and Eleventh Circuits released four opinions, two of which potentially enlarge the SEC's tool kit in seeking to punish wrongdoing, one that could pare back the SEC's reach, and finally one that is useful in addressing potential collateral consequences of SEC "neither admit nor deny" settlements in subsequent litigation. Each has the potential to influence litigated matters involving SEC investigations that are currently pending before federal courts, and may well have an impact even at the investigative stage.

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SECOND CIRCUIT CLARIFIES THAT SEC IS NOT REQUIRED TO PLEAD PROXIMATE CAUSATION FOR AIDING & ABETTING CLAIMS

In a holding that some commentators have suggested eases the requirements for the SEC in charging secondary actors with securities law violations, *SEC v. Apuzzo*, the Second Circuit clarified that the SEC does not need to allege that a defendant proximately or directly caused a securities law violation to prove that the defendant "substantially assisted" the violation, one of the requisite elements of aiding and abetting liability.[1]

In its complaint, the SEC alleged that the defendant, Joseph Apuzzo, formerly the CFO of Terex Corp., aided and abetted violations involving a fraudulent accounting scheme allegedly orchestrated by the former CFO of United Rentals, Inc., one of Terex's customers. In the district court proceedings, Apuzzo moved to dismiss the complaint, arguing that it failed to allege two of the three required elements of an aiding and abetting violation: (i) that the defendant had knowledge of the fraud, and (ii) that the defendant substantially assisted the primary violator's misconduct.[2]

The district court found that the SEC met its pleading burden on the knowledge element, but failed to adequately allege substantial assistance and granted Apuzzo's motion to dismiss. The court explained that "the complaint contains factual allegations which taken as true support a conclusion that there was a 'but for' causal relationship between Apuzzo's conduct and the primary violation, but do not support a conclusion that Apuzzo's conduct proximately caused the primary violation."[3] The court reasoned that, absent allegations of proximate causation, the complaint failed to adequately plead the required substantial assistance element.

In reversing the district court's decision, Judge Rakoff, writing by designation of the Second Circuit, drew a distinction between private civil actions and SEC enforcement actions, observing that "'[p]roximate cause' is the language of private tort actions; it derives from the need of a private plaintiff, seeking compensation, to show that his injury was proximately caused by the defendants' actions. But, in a government enforcement action, civil or criminal, there is no requirement that the government prove injury, because the purpose of such actions is deterrence, not compensation."[4] Acknowledging

that this distinction had been blurred in other decisions addressing this topic, Judge Rakoff took the opportunity to clarify that, in the Second Circuit, the SEC does not need to plead or prove proximate causation in connection with an aiding and abetting claim.[5]

The Second Circuit pointed to a test articulated by Judge Learned Hand in a 1938 criminal aiding and abetting prosecution, in which he stated that, in addition to establishing that the primary violation occurred and that the defendant had knowledge of it, the government also must prove that the defendant associated himself with the venture, participated in it as something that he wished to bring about, and sought by his action to make it succeed.[6] The Apuzzo court found that the SEC satisfied this test.

Some commentators have asserted that the Apuzzo decision eases the SEC's burden in pleading aiding and abetting claims, arguing that the Learned Hand standard is less stringent than the standard required for showing proximate causation. This is not necessarily correct in light of the Second Circuit's application of the standard and discussion of the SEC's allegations, including the court's view that the complaint alleged a very high degree of knowledge of fraud on the defendant's part.[7]

While the Second Circuit's clarification of the pleading standard is noteworthy, in our view the more remarkable takeaway from the Apuzzo decision is the fact that the defendant, an outsider who merely did business with and was not employed by the reporting company where the alleged primary violations occurred, was targeted for aiding and abetting the violations of the reporting company. While such a claim by the SEC is not new, this opinion highlights the significant exposure an outside party potentially faces in entering into a transaction, especially in the context of a claim under Section 20(e) of the Securities Exchange Act of 1934 ("Exchange Act") post Dodd-Frank, under which the SEC is no longer required to plead and prove "knowing" substantial assistance to another, but instead may simply allege "recklessness."[8] The new legal standard should not reach a commercial counterparty engaged in a legitimate business transaction — we believe that an important factor in this case was the nature of the alleged misconduct of the defendant — but the case highlights that, as a matter of prudence and risk control, all transacting parties should take steps to enter into accurately documented and appropriate business relationships.

The potential exposure of outside parties like Apuzzo is particularly acute in the current political environment, where there continues to be unwavering pressure on the SEC to seek to hold individuals accountable. *See*, for example, Senator Reed's recent comment: "A lot of people on the street, they're wondering how a company can commit serious violations of securities laws and yet no individuals seem to be involved and no individual responsibility was assessed."[9] In this environment, and in light of recent opinions like Janus Capital Group that have made it potentially more difficult for the SEC to pursue individuals for violations of Rule 10b-5 of the Exchange Act, it is possible that the agency will more aggressively pursue aiding abetting claims like those in Apuzzo.

Taking all of these items together, it is not surprising that SEC Enforcement Director Robert Khuzami has expressed the view that the Second Circuit's decision "will help [the SEC] hold responsible those who aid and assist financial frauds."[10]

ELEVENTH CIRCUIT EXPANDS DISGORGEMENT REMEDY TO INCLUDE SALARIES

In another ruling that could have far reaching consequences for the Enforcement program, *SEC v. Merchant Capital LLC*, the Eleventh Circuit bolstered the SEC's remedial relief tool kit by affirming a district court's decision to take into account the salaries of alleged wrongdoers in setting disgorgement.[11]

In the lower court proceedings, the defendants were found liable for antifraud violations related to investment contracts. In setting disgorgement, the district considered the amount of salaries obtained by the two individual defendants from their employer and ordered them to pay disgorgement and prejudgment interest of $1,164,792 and $422,048 respectively.[12] The defendants appealed, arguing that the disgorgement amounts set by the lower court did not reasonably approximate their unjust enrichment, failed to take into account income taxes paid on the salaries, and were not "commensurate with their levels of experience and sophistication or the complexity" of their business.[13] They also asserted that their salaries were "modest and reasonable" and therefore did not constitute ill-gotten gains.[14]

In an unpublished per curium opinion, the Eleventh Circuit disagreed,

finding that the lower court did not abuse its discretion in considering the defendants' salaries in setting disgorgement. The court explained that the SEC may seek disgorgement after producing a reasonable approximation of the defendant's ill-gotten gain, and that the burden is on the defendant to show that the SEC's estimate is not reasonable.[15] The court found that the defendants failed to meet that burden, and explained that it was not aware of any authority supporting the argument that a wrongdoer's salary should not be subject to disgorgement if modest and/or reasonable. "The purpose of disgorgement is to deprive the wrongdoer of his ill-gotten gain . . . and there is no reason why salaries earned cannot be used to determine disgorgement. Here it is undisputed that the amount of disgorgement ordered by the district court was a reasonable approximation of the salaries received by Messrs. Wyer and Beasley from Merchant Capital."[16] The court reasoned that the defendants' salaries were derived from fees earned in connection with the alleged misconduct, and therefore constituted ill-gotten gains appropriately subject to disgorgement.

This ruling represents a potentially worrisome expansion of the SEC's authority to seek remedial relief. Traditionally, the disgorgement remedy has been used as a means of recovering profits derived from illegal activity, funds misappropriated from customers or employers, and other illicit windfalls realized in connection with the alleged misconduct. Although the appellate court noted a linkage between the defendants' salaries and the underlying violations, the manner in which the Eleventh Circuit designated routine compensation as a viable source of disgorgement in this case potentially expands the SEC's reach in seeking remedial relief from defendants.

FIFTH CIRCUIT REIGNS IN STATUTES OF LIMITATIONS FOR SEC INJUNCTIVE ACTIONS

In a third ruling of note, *SEC v. Bartek*, the Fifth Circuit held that SEC actions seeking injunctive relief and officer and director bars constitute "penalties" and are therefore subject to the five-year statute of limitations prescribed by 28 U.S.C. § 2462.[17]

In its complaint, the SEC alleged that the defendants violated the securities laws by fraudulently backdating stock options of their employer, Micro-

tune. The SEC sought remedial relief including permanent injunctions, civil penalties, and officer and director bars. In the district court proceedings, the defendants moved for summary judgment, arguing that the alleged misconduct occurred outside the applicable statute of limitations period.[18]

The district court agreed with the defendants, holding that all of the sought-after remedies constituted "penalties" under § 2462 and, therefore, were time-barred. The court reasoned that each form of remedial relief sought by the SEC — including injunctive relief and officer and director bars — would have significant collateral consequences to the defendants, would not address past harms caused by the defendants, and were not likely to prevent future harm.[19]

On appeal, the SEC argued that the time bar under § 2462 applies only to sanctions involving the collection of money or property, not equitable remedies such as injunctions and officer and director bars. In an unpublished, per curiam decision, the Fifth Circuit disagreed with the SEC's narrow interpretation of the meaning of a penalty under § 2462, observing that the "SEC's sought-after remedies would have a stigmatizing effect and long-lasting repercussions. Neither remedy addresses past harm allegedly caused by the Defendants. Nor does either remedy address the prevention of future harm in light of the minimal likelihood of similar conduct in the future."[20]

The court further noted that the SEC was, in essence, seeking a lifetime ban against the defendants, which courts have interpreted to be punitive in nature. "Based on the severity and permanent nature of the sought-after remedies, the district court did not error in denying the SEC's request on grounds that the remedies are punitive, and are thus subject to § 2462's time limitations."[21]

The Fifth Circuit also rejected the SEC's arguments that its claims nevertheless were timely because the statute of limitations did not begin to run until the agency discovered the existence of the alleged options backdating violations. The court found that a "plain reading of § 2462 reveals no discovery rule exception.… Congress did not include language to toll the statute based on an accrual discovery rule," although it expressly included other specific exceptions to the applicability of the statute.[22] The court distinguished opinions from the Supreme Court and Second and Seventh Circuits, cited by the SEC in support of its argument that the discovery rule applies in fraud cases,[23] reasoning that they involved "self-concealing" frauds not present in Bartek.[24]

This ruling, which the SEC likely would argue represents a substantial departure from precedent in at least three other circuits (First, Ninth, and Eleventh), is a blow to the SEC's ability to seek remedial relief. In our view, it appropriately recognizes the punitive nature of two of the sanctions that are the lifeblood of the SEC Enforcement program — injunctions and officer and director bars — and puts reasonable limits on the SEC's ability to pursue such relief years and years after the alleged misconduct occurred. It serves as an important reminder of the need to conduct and conclude investigations in a timely fashion, even in the wake of a number of changes implemented in recent years aimed at making the Enforcement process more efficient. The ruling also is notable in that it could serve as a basis for future arguments that another form of remedial relief commonly imposed in enforcement cases — disgorgement — likewise should be subject to the limitations period in § 2462.

NINTH CIRCUIT HOLDS SEC CIVIL COMPLAINT INADMISSIBLE IN CRIMINAL TRIAL

In another decision that could impact litigation involving SEC investigations, *U.S. v. Bailey*, the Ninth Circuit held that a civil complaint filed by the SEC in earlier litigation could not be admitted into evidence in the defendant's criminal trial for related conduct.[25]

The defendant and his company were sued by the SEC for alleged violations of the Securities Act of 1933 ("Securities Act") involving allegations of misconduct in the distribution of securities. The defendant and the SEC settled the matter before trial, on a neither admit nor deny basis. The defendant was criminally charged a year later. While the criminal charges were based on different facts, the charges included allegations that the defendants violated the same provisions of the Securities Act that the defendant was alleged to have violated in the previous SEC complaint. At trial, the district court allowed the prosecution to introduce the prior SEC complaint as evidence that the defendant knew his conduct was unlawful and that he was required to comply with the applicable securities laws.[26] After the complaint was introduced into evidence, the prosecution also argued that it supported a showing of the defendant's intent to commit the alleged violations.[27] The jury found the defendant guilty and he was sentenced to thirty months in jail.

The defendant appealed, arguing that admission of the SEC complaint into evidence was improper. The defendant asserted that the civil complaint constituted impermissible "other act evidence" under FRE 404(a), which prohibits the introduction of evidence of a "person's character or character trait … to prove that on a particular occasion the person acted in accordance with the character or trait."[28] The government countered that the complaint was introduced to show proof of knowledge and intent, and therefore its admission was appropriate under FRE 404(b), which permits the introduction of evidence for certain purposes, such as "proving motive, opportunity, intent, preparation, plan, knowledge, identity, absence of mistake, or lack of accident."[29]

The Ninth Circuit sided with the defendant, reasoning that the complaint was merely a recitation of accusations and did not constitute a finding of fact that the alleged violations occurred. The court found that "[a]dmitting prior conduct charged but settled with no admission of liability is not probative of whether the defendant committed the prior conduct, much less whether he committed the conduct in question," and concluded that there "is no logical relevancy to admitting this type of evidence."[30] The court expressed concern that admitting the complaint "may have permitted the jurors to succumb to the simplistic reasoning that if the defendant was accused of the conduct, it probably or actually occurred," which is an impermissible inference.[31]

Although *U.S. v. Bailey* involved a criminal proceeding, the decision is an important one that could be relied upon by defendants litigating with the SEC or private plaintiffs to keep settled complaints filed by the agency in other litigation out of evidence. In our view, the Ninth Circuit arrived at the right conclusion. By definition, a complaint is a collection of unproven allegations, not findings of fact, drafted by the plaintiff to put the defendant in the most unfavorable light and to advance the complaining party's position. Although there is some precedent for introducing into evidence SEC findings of fact for limited purposes,[32] allowing SEC complaints into evidence would encourage exactly the type of negative inference the Ninth Circuit found to be impermissible, and would give a plaintiff an unfair and inappropriate advantage in litigation, particularly if a jury is the finder of fact. Moreover, because findings of fact or agreements to not dispute, contest, or contradict

facts typically occur only in connection with certain types of SEC proceedings (e.g., administrative proceedings and proceedings resolved with non-prosecution or deferred prosecution agreements), the potential difference in treating those findings or statements of fact, on the one hand, and allegations in a federal court complaint, on the other hand, could be a factor in deciding which form of settlement might be preferred by a potential defendant in an SEC proceeding.

The decision also is noteworthy because it highlights the ongoing debate over the propriety of SEC settlements made on a "neither admit nor deny" basis. Here, as is typical in SEC settlements, the defendant settled the civil litigation without admitting or denying the factual allegations, as well as liability, so there were no findings of fact or admissions that could be introduced at the criminal trial. Instead, the prosecution attempted to rely on the SEC complaint as evidence of the defendant's knowledge and intent, but was denied by the Ninth Circuit. As the debate over the appropriateness of neither admit nor deny settlements continues,[33] this decision is likely to be cited by those who favor requiring admissions from settling defendants.

CONCLUSION

Each of the decisions is important and no doubt had an important impact in the particular matter in which they arose. Beyond these individual matters, however, these decisions reflect significant developments in the areas of the legal standards for seeking to charge, try, and sanction those who are alleged to have violated the federal securities laws.

NOTES

1 *SEC v. Apuzzo*, No. 11-cv-696 (2d Cir. August 8, 2012).
2 *Id.* at 10.
3 *SEC v. Apuzzo*, 758 F. Supp. 2d 136, 152 (D. Conn. 2010).
4 *Supra* note 1 at 13.
5 *Id.* at 14-15.
6 *Id.* at 12.
7 *Id.* at 15-18.
8 15 USC § 78t(e) ("[A]ny person that knowingly or recklessly provides

substantial assistance to another person in violation of a provision of this chapter, or of any rule or regulation issued under this chapter, shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided.").

[9] Corporate Fraud Cases Often Spare Individuals, NEW YORK TIMES (Aug. 7, 2012), available at http://www.nytimes.com/2012/08/08/business/more-fraud-settlements-for-companies-but-rarely-individuals.html.

[10] U.S. Court Eases SEC Burden to Show Defendant Aided Fraud, CHICAGO TRIBUNE (Aug. 8, 2012), available at http://articles.chicagotribune.com/2012-08-08/news/sns-rt-sec-fraudrulingl2e8j85zt-20120808_1_sec-enforcement-sec-civil-case-appeals-court.

[11] *SEC v. Merchant Capital LLC*, No. 11-cv-14908 (11th Cir. Aug. 7, 2012).

[12] *SEC v. Merchant Capital LLC*, No. 02-cv-2984 (N.D. Ga. Apr. 25, 2011).

[13] *Supra* note 12 at 6.

[14] *Id.*

[15] *Id.* at 6-7.

[16] *Id.* at 7.

[17] *SEC v. Bartek*, No. 11-cv-10594 (5th Cir. Aug. 7, 2012).

[18] *Id.* at 3.

[19] *Id.* at 10.

[20] *Id.* at 13.

[21] *Id.*

[22] *Id.* at 6.

[23] *See, e.g., Merck & Co. v. Reynolds*, 130 S. Ct. 1784 (2010); *S.E.C. v. Koenig*, 557 F.3d 736 (7th Cir. 2009); and *S.E.C. v. Gabelli*, 653 F.3d 49 (2d Cir. 2011).

[24] *Supra* note 18 at 8-10.

[25] *U.S. v. Bailey*, 09-cv-00327 (9th Cir. Aug. 27, 2012).

[26] *Id.* at 9728.

[27] *Id.* at 9731.

[28] Federal Rule of Evidence § 404(a)(1).

[29] Federal Rule of Evidence § 404(b)(2).

[30] *Supra* note 26 at 9735.

[31] *Id.* at 9735-36.

[32] *See, e.g., Option Resource Group v. Chambers Dev. Co., Inc.*, 967 F. Supp. 846, 850 (W.D. Pa. 1996) (finding the SEC's opinions, conclusions, and findings of fact contained in settlement materials admissible for summary judgment, but not addressing whether admissible at trial); *SEC v. Pentagon Capital Mgmt. PLC*,

2010 WL 985205 *2 (S.D.N.Y. Mar. 17, 2010) (allowing SEC findings of fact in administrative proceeding into evidence where defendant was seeking to use the findings as a "shield" in his defense); *but see Carpenters Health & Welfare Fund v. The Coca-Cola Co*., No. 00-CV-2838, Slip Op. (N.D. Ga. Apr. 23, 2008) (refusing to allow SEC finding of facts into evidence, reasoning that doing so would have a chilling effect on the settlement process); *Lipsky v. Commonwealth United Corp*., 551 F.2d 887, 893 (2d Cir. 1976) (refusing to admit a consent judgment and complaint in an SEC civil action, finding that they were not true adjudications of the underlying issues).

[33] *See, e.g.*, SEC Enforcement: Pitt, Academics Urge 2d Cir. to Affirm Rakoff Rejection, Corporate Counsel Weekly (Aug. 29, 1012) (reporting on amicus brief filed by legal scholars encouraging Second Circuit to affirm Judge Rakoff's rejection of the settlement in *SEC v. Citigroup Global Markets* as contrary to public policy).