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REPORT

Jurisdiction and Procedure

Averse to Adverse Inferences? Rethinking the Scope Of the Fifth Amendment Protections in SEC Proceedings

By Tom Hanusik

Having a constitutional right does not always mean that you can exercise it freely. Take, for example, the right not to become a witness against yourself.[1] It sounds perfectly reasonable – you cannot be forced to provide testimony against yourself – but there may be consequences for exercising this right in certain settings that are neither foreseeable nor warranted. One such setting is an enforcement proceeding commenced by the United States Securities and Exchange Commission ("SEC"). This article will explore the current implications of exercising the right not to incriminate yourself in an SEC enforcement proceeding and analyze whether those implications are warranted or justified.

[1] In the landmark decision of *Miranda v. Arizona*, 384 U.S. 436 (1966), the Supreme Court held that a person in police custody must be informed of their right to remain silent and their right to counsel.

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The Privilege against Self-Incrimination

The Fifth Amendment to the United States Constitution provides in pertinent part:

> No person . . . shall be compelled in any criminal case to be a witness against himself . . .[2]

Known as the privilege against self-incrimination, or, more colloquially, taking the Fifth, this language extends beyond situations where a confession to a crime would be forthcoming but for its invocation. Indeed, the Supreme Court has held that the privilege against self-incrimination "protects the innocent as well as the guilty."[3] The only limitation on this protection is that the person invoking the privilege must have "reasonable cause to apprehend danger from a direct answer."[4]

It is well established that the privilege against self-incrimination applies in civil as well as criminal cases,

[2] U.S. Const. amend. V.
[3] *Ohio v. Reiner*, 532 U.S. 17, 18 (2001).
[4] *Id.* at 21 (quoting *Hoffman v. United States*, 341 U.S. 479, 486 (1951)).

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particularly when immunity is not conferred before testimony is sought.[5] As Justice Brandeis eloquently stated in *McCarthy v. Arndstein*:

> The privilege is not ordinarily dependent upon the nature of the proceeding in which the testimony is sought or is to be used. **It applies alike to civil and criminal proceedings, wherever the answer might tend to subject to criminal responsibility him who gives it.** The privilege protects a mere witness as fully as it does one who is also a party defendant.
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> . . . .
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> [H]e may, like any other witness, assert the constitutional privilege; because the present statute fails to afford complete immunity from prosecution.[6]

However, invoking the privilege against self-incrimination in a civil case is not without risk. In fact, such an invocation can tip the balance and result in a finding of liability in a civil lawsuit. This outcome can occur if a party opponent succeeds in having a court draw an ''adverse inference'' against a party that takes the Fifth.

The 'Adverse Inference'

An adverse inference is an inference of guilt in a criminal case or liability in a civil case.[7] A trier of fact in a criminal case, be it a judge or jury, cannot draw an adverse inference against a defendant who declines to testify.[8] In practice, juries hearing criminal cases are routinely instructed that they cannot even consider a defendant's decision not to testify.[9] This instruction correctly reflects the premise that an adverse inference against a non-testifying criminal defendant would tend to ''discount a defendant's constitutional rights.''[10] The Fifth Amendment's protections, however, extend beyond criminal defendants. As the Supreme Court has held, the Fifth Amendment:

> not only protects the individual against being involuntarily called as a witness against himself in a criminal prosecution, but also privileges him not to answer official questions put to him in any other proceeding, civil or criminal, formal or informal, where the answers might incriminate him in future criminal proceedings.[11]

Although it is firmly established that the privilege against self-incrimination applies in civil cases, American jurisprudence nonetheless allows civil judges and juries to penalize defendants by inferring liability when those defendants invoke the privilege against self-incrimination.

In *Baxter v. Palmigiano*, the Supreme Court held that the privilege against self-incrimination extended to a civil prison disciplinary proceeding that had potential criminal consequences.[12] Palmigiano allegedly encouraged his fellow inmates to refuse to return to their cells for night lockdown as a form of protest and he was subject to a disciplinary proceeding for inciting a riot, which was also potentially chargeable as a separate criminal offense.[13] The Supreme Court held that Palmigiano had a Fifth Amendment right to avoid answering questions during the prison disciplinary proceeding, but also that the prison authorities could draw an adverse inference against him for taking the Fifth.[14] The Court reasoned as follows:

> [T]he Fifth Amendment does not forbid adverse inferences against parties to civil actions when they refuse to testify in response to probative evidence offered against them: the Amendment ''does not preclude the inference where the privilege is claimed by a party to a civil cause.''[15]

Thus, although the Court agreed that the privilege against self-incrimination applied in a civil matter, it nonetheless allowed a penalty to be imposed against Mr. Palmigiano for asserting a constitutional right.

Unlike individuals, companies as collective entities do not have a Fifth Amendment right against self-incrimination.[16] However, the dilemma facing individuals can also impact companies as some courts have drawn adverse inferences against companies when non-party employees and even former employees refuse to testify on Fifth Amendment grounds.[17]

SEC Practice

Since *Palmigiano*, adverse inferences have been sought and utilized routinely by the SEC's Division of Enforcement when individual defendants in SEC matters choose to exercise their Fifth Amendment right against self-incrimination rather than testify.[18] The SEC's Enforcement Manual specifically notes that ''During Litigation, the SEC can assert that an adverse inference should be drawn against an individual who has asserted the Fifth Amendment privilege.''[19] However, the use of an adverse inference poses more challenging questions in the SEC enforcement realm because the SEC's Division of Enforcement investigates and prosecutes the same laws and rules, albeit with different intent requirements and burdens of proof, as criminal prosecutors at the United States Department of Justice (''DOJ''). In other words, alleged violations may rely on the exact same facts, circumstances and statutes, and parallel investigations by SEC and DOJ invariably plow the same ground.[20] Moreover, the SEC

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[5] *McCarthy v. Arndstein*, 266 U.S. 34, 40 (1924).
[6] *Id*. at 40-42 (emphasis added).
[7] *Baxter v. Palmigiano*, 425 U.S. 308, 317 (1976).
[8] *Griffin v. California*, 380 U.S. 609, 614-15 (1965).
[9] *See, e.g., Carter* v. *Kentucky*, 450 U. S. 288 (1981).
[10] *Brink's Inc. v. City of New York*, 717 F.2d 700, 709 (2d Cir. 1983).
[11] *Lefkowitz v. Turley*, 414 U.S. 70, 77 (1973).
[12] *Baxter*, 425 U.S. at 317-318.
[13] *Id*.
[14] *Id*.
[15] *Id*. (quoting 8 J. Wigmore, *Evidence* 439 (McNaughton rev. 1961)).
[16] *See*, *e.g.*, *Braswell v. United States*, 487 U.S. 99, 104-111 (1988) and *United States v. White*, 322 U.S. 694, 698 (1944).
[17] *Brink's Inc. v. City of New York*, 717 F.2d 700 (2d Cir. 1983).
[18] *See*, *e.g.*, *SEC v. Cherif*, 933 F.2d 403, 417 (7th Cir. 1991), *cert. denied*, 502 U.S. 1071 (1992); *SEC v. Musella*, 578 F. Supp. 425, 429 (S.D.N.Y. 1984).
[19] Securities and Exchange Commission Division of Enforcement, *Enforcement Manual* § 4.1.3 at 96 (October 6, 2008), *available at*: www.sec.gov/divisions/enforce/enforcementmanual.pdf.
[20] The provisions and rules thereunder of the Securities Act of 1933 and the Securities Exchange Act of 1934 are criminalized by sections in those acts which make willful violations criminal acts. *See*, 15 U.S.C. § 77x (2004) and 15 U.S.C. § 78ff (2004). In addition, the antifraud provisions of these acts can easily be converted to violations of the federal mail, wire and securities fraud felony provisions under Title 18. *See*, 18 U.S.C. §§ 1341, 1343 and 1348, provided there is a use of the interstate wires, mails or fraud in connection with a security.

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can impose monetary penalties, injunctions, industry bans and bar orders, possibly ending the careers of and bankrupting those who commit civil violations of the federal securities laws.

To its credit, the SEC recognizes that people it investigates and prosecutes have a Fifth Amendment privilege against self-incrimination. The Division of Enforcement, as a matter of course, informs every person asked to provide information, voluntarily or by subpoena, of that right. Specifically, everyone from whom the SEC seeks information is provided an SEC Form 1662 which states in pertinent part:

> 5. *Fifth Amendment and Voluntary Testimony*. Information you give may be used against you in any federal, state, local or foreign administrative, civil or criminal proceeding brought by the Commission or any other agency.
>
> You may refuse, in accordance with the rights guaranteed to you by the Fifth Amendment to the Constitution of the United States, to give any information that may tend to incriminate you or subject you to fine, penalty or forfeiture.[21]

While the SEC informs people that it may use their words against them, the SEC Form 1662 provides no notice whatsoever that the SEC may be able to impose a penalty on those who take the Fifth and refuse to testify by drawing an adverse inference against them in subsequent litigation.[22]

Moreover, the SEC Form 1662 informs witnesses that the SEC routinely provides information gathered in the course of its investigations to other investigative agencies, most notably criminal prosecutors at DOJ. This overlap between the role of the SEC and that of DOJ, often working in concert with each other albeit on supposedly separate, or parallel, tracks, makes the utilization of an adverse inference in SEC Enforcement proceedings all the more troubling.

From a practical standpoint, someone from whom the SEC is seeking information is almost encouraged not to provide any by the SEC Form 1662. First, the form states that witnesses have the right not to testify. Second, it states—*Miranda* style—that any information provided by witnesses may be used against them. And, finally, the witnesses are warned that the information they provide may be shared with federal prosecutors who enforce the very same laws and regulations, albeit with far more dire consequences.[23] What the witnesses are not told by the SEC, however, is that if they choose to exercise their constitutional right not to testify such a choice can have a detrimental impact on their ability to defend themselves against an action filed by the SEC. And therein lies the problem – witnesses before the SEC are told that they have certain rights and they are even told what consequences might occur from waiving them, but they are not told about the negative consequences of exercising those rights.[24]

The omission from the SEC Form 1662 would be difficult to cure by simply adding a warning about the possibility of an adverse inference. Any suggestion that exercising a constitutional right could have an adverse impact on a witness should be viewed with skepticism by a reviewing court since the implication would be that the witness was being discouraged from exercising that right by the government.

Parallel SEC and DOJ Investigations

The SEC, of course, has a different view. From its perspective —one thus far adopted by courts—the invocation of the privilege against self-incrimination during SEC enforcement actions is a means of obstructing or otherwise hindering the SEC's efforts to enforce the federal securities laws.[25] From this vantage point, the effects of invoking a constitutional right must be corrected, or moderated, by allowing the trier of fact to draw an adverse inference against a party invoking that right.[26] However, this vantage point has far less validity in the post-Enron corporate fraud law enforcement environment where the SEC and DOJ routinely work in tandem and where civil and criminal cases are routinely filed simultaneously.[27]

Ironically, DOJ is not necessarily in concert with SEC on this issue. Indeed, DOJ has argued that defense counsel should not be able to cross-examine a government witness about his invocation of the Fifth Amendment ''because the invocation of privilege has little or no probative purpose, and therefore undue prejudice is likely to result.''[28] Thus, when it comes to protecting its own witnesses who invoke the privilege against self-incrimination but are not criminal defendants, the government has no difficulty arguing that invoking the Fifth has no probative value. However, when a defendant in an SEC case tries to invoke the same constitutional right, the government seeks to penalize that person by imposing an inference that the defendant violated the law.

Another important consideration is that the SEC has a lower burden of proof in its civil enforcement proceedings than a criminal prosecutor at DOJ. A criminal prosecutor must prove guilt ''beyond a reasonable doubt,'' but the Division of Enforcement is a civil law enforcement entity and, as such, is only required to prove liability ''by a preponderance of the evidence.''[29] However, the burden of proof is still being applied to

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[21] SEC Form 1662, Testimony, § 5 (5-04).

[22] Although difficult to quantify, there is little doubt that the Staff also makes the Commission aware that a putative defendant has taken the Fifth when seeking permission to file an enforcement action, thereby extending the ''adverse inference'' back to the charging stage.

[23] SEC Form 1662, Testimony, § 5, and Routine Uses of Information , *passim* (5-04).

[24] To be clear, the dilemma facing witnesses before the SEC cannot be cured by adding a notice to the Form 1662 that warns about possibility of an adverse inference if someone exercises the right to remain silent. Indeed, one can imagine the hornet's nest of litigation that would ensue if the SEC notified witnesses that they had certain rights in one breadth and told them of the penalties that would be imposed for exercising them in the next.

[25] *Musella*, 578 F. Supp. at 429 (invoking the privilege ''cripples plaintiff's efforts to conduct meaningful discovery and to marshal proof in an expeditious fashion. . . .''); *see also SEC v. Graystone Nash, Inc.*, 25 F.3d 187, 190 (3d Cir. 1994).

[26] *Id.*

[27] The fact that DOJ often seeks, with some success, to stay the simultaneously filed SEC case pending the outcome of the criminal proceeding is of scant value. *See*, *e.g.*, *United States v. Kordel*, 397 U.S. 1, 11 (1970). The justification for seeking such stays is not because the defendant would be deprived of the right against self-incrimination but to stop the defendant from having access to discovery under the more liberal civil rules that govern SEC enforcement actions.

[28] *United States v. Colasuonno*, 05 Cr. 1110, 2006 WL 3025880, at *2 (S.D.N.Y. Oct. 24, 2006).

[29] *Herman & MacLean v. Huddleston*, 459 U.S. 375, 390 (1983); *SEC v. Moran*, 922 F. Supp. 867, 887 (S.D.N.Y 1996).

the same exact alleged statutory violations. Although jail time will not result directly from an SEC proceeding, the Division of Enforcement can still take all of a defendant's money, end a defendant's career and ban that person from the securities industry or an officer/director position forever. Put more plainly, the SEC can unleash a significant arsenal of punitive sanctions on a defendant and they have an easier path to that end in terms of the burden of proof. This dilemma for defendants is compounded by the reality that many, if not most, SEC enforcement cases rely extensively on circumstantial evidence.

Given the extensive nature of the sanctions it can impose, the SEC ought to be able to prove violations of the federal securities laws and regulations without an inference that the accused must have committed a certain act if they refuse to provide testimony about it. Add to those factors the already lower burden of proof the SEC must overcome to impose those sanctions, and one has to wonder why courts would make it even easier for the SEC to succeed by imposing an adverse inference against a defendant who exercises a constitutional right.

There is also a difference in the intent element necessary to prove a civil versus criminal securities violation, but that difference is not meaningful to the discussion of whether or not the invocation of a constitutional right should have a negative repercussion. Whether someone willfully or knowingly violates a federal law is inconsequential to whether they should have a right against self-incrimination. Moreover, for the very few out there who can articulate a meaningful distinction between a willful and knowing violation, it should come as no surprise that Congress can always decide to remove this minor practical distinction without any impact whatsoever on when an adverse inference can be drawn against a defendant who takes the Fifth.

Eliminating the Adverse Inference in SEC Cases

Future efforts by the SEC to draw an adverse inference against a non-testifying defendant may be analyzed with greater scrutiny given recent developments in the law. In *United States v. Stein, et al.*, the Second Circuit Court of Appeals affirmed a lower court decision imposing the drastic remedy of dismissing an indictment.[30] In *Stein*, the court held that the government interfered with the defendant's Sixth Amendment right to counsel by causing the defendants' employer to adopt and enforce a policy that conditioned the payment of defendants' legal fees on their cooperation with the government.[31] As the Court stated:

> We hold that KPMG's adoption and enforcement of a policy under which it conditioned, capped and ultimately ceased advancing legal fees to defendants followed as a direct consequence of the government's overwhelming influence, and that KPMG's conduct therefore amounted to state action. We further hold that the government thus unjustifiably interfered with defendants' relationship with counsel and their ability to mount a defense, in violation of the Sixth Amendment, and that the government did not cure the violation. Because no other remedy will return defendants to the status quo ante, we affirm the dismissal of the indictment as to all thirteen defendants.[32]

The Second Circuit did not reach the Fifth Amendment due process claim put forward by the defendants, having determined that dismissal of the indictment was appropriate under a Sixth Amendment analysis and thereby making further analysis unnecessary. However, the court's Sixth Amendment analysis is also instructive on the question of whether the imposition of an adverse inference by the government in a civil case that runs parallel to a criminal prosecution is appropriate.[33]

The law is clear that the right against self-incrimination applies equally in criminal and civil cases. It is also clear, and appropriate, that courts forbid any consideration of a defendant's invocation of the right against self-incrimination in a criminal case. However, the law as currently interpreted permits the government to draw an adverse inference against a defendant for such an invocation in civil cases. When a case is purely civil, as when both parties are non-governmental entities, such an inference *may* make sense if it is determined that one party is invoking the privilege in order to thwart otherwise legitimate discovery efforts.[34] However, when a government agency is involved in a case—particularly when that agency has investigatory subpoena power and is using its civil law enforcement authority to enforce the exact same statutes that constitute criminal charges—defendants confront a catch-22 between invoking a constitutional right that could result in an adverse inference and waiving a constitutional right and assisting a criminal case against themselves. That choice is neither appealing nor necessary and arguably unconstitutional. The dilemma created by forcing an individual to make such a choice is compounded because failing to affirmatively invoke the privilege against self-incrimination can be interpreted as a waiver of that right.[35]

If, as the Supreme Court has stated, the Fifth Amendment protects both the innocent and the guilty, then it makes little sense to penalize the innocent for invoking a constitutional protection by inferring that they have committed the act accused of in the context of parallel SEC and DOJ investigations. Eliminating the imposition of an adverse inference as a consequence of asserting a basic constitutional right would go a long way toward giving real meaning to the ''rights'' individuals are informed about in the SEC's Form 1662. This approach

[30] *United States v. Stein*, 541 F.3d 130 (2nd Cir. 2008).
[31] *Id.* at 136.
[32] *Id.*
[33] There is also an apt analogy for situations when the government pressures companies that are striving to obtain credit for cooperation to part ways with employees the government deems uncooperative. Under the *Stein* analysis, one can foresee a future court interpreting such pressure as an unconstitutional interference with an individual's Fifth Amendment right against self-incrimination, much as the Second Circuit held that the government's meddling into the payment of private attorney's fees was an unconstitutional interference with the defendants' Sixth Amendment rights.
[34] There may also be situations involving litigation with the government where an adverse inference is legitimate because there is a finding of obstructive behavior or abuse of the privilege against self-incrimination, just as it can be legitimate when a party destroys relevant evidence.
[35] *Minnesota v. Murphy*, 465 U.S. 420, 428 (1984). *See also United States v. Unruh*, 855 F.2d 1363, 1374 (9th Cir. 1987) (holding that a defendant waived the privilege when, after being advised of his right not to answer questions, he proceeded to testify in a civil deposition).

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would maintain the true protections against self-incrimination afforded by the Fifth Amendment while also not prejudicing the government's efforts to enforce laws that have civil and criminal sanctions. The SEC can always move to stay its enforcement proceeding pending the outcome of a parallel criminal investigation, a remedy routinely sought by DOJ to thwart efforts at civil discovery by criminal defendants.[36]

Conclusion

The cold reality facing every person caught up in the wide net of securities fraud investigations jointly conducted by SEC and DOJ is that if a criminal charge is successful, an SEC civil charge is routinely successful on a motion for summary judgment based on the conviction at the higher burden of proof and level of intent. Since an adverse inference alone is insufficient to prove a case even by a preponderance of the evidence, drawing the adverse inference may have a very limited impact on an SEC case, while undoubtedly deterring defendants from taking the Fifth. However, the adverse inference for a defendant is a form of burden shifting and a penalty for exercising a constitutional right. Allowing the SEC to continue to draw an adverse inference against individuals who take the Fifth is a deterrent to the exercise of a valid constitutional right. The time has come to rethink whether such a deterrent by a government agency that has concurrent jurisdiction with federal criminal prosecutors is either wise or constitutional.

[36] *See, e.g., Securities and Exchange Commission v. Dresser Industries, Inc.*, 628 F.2d 1368, 1375-76 (D.C. Cir.), *cert. denied*, 449 U.S. 993 (1980).