

TO NEITHER ADMIT NOR DENY: SEC LITIGATION POSITION REITERATES NEED TO EXAMINE STANDARD PROVISIONS IN SEC SETTLEMENTS

Experienced securities enforcement practitioners know that the Securities and Exchange Commission (the “Commission”) employs certain boilerplate language in its settlement documents, both for administrative proceedings and injunctive actions. Although one of the benefits to a defendant or respondent settling with the Commission is that he/she is not required to admit the underlying allegations, the Commission nevertheless, as a matter of standard practice, insists that the following language be included in its settlement documents:

Defendant [X] understands and agrees to comply with the Commission’s policy “not to permit a defendant or respondent to consent to a judgment or order that imposes a sanction while denying the allegations in the complaint or order for proceedings” (17 C.F.R. § 202.5(e)). In compliance with this policy, Defendant [X] agrees not to take any action or to make or permit to be made any public statement denying, directly or indirectly, any allegation in the Complaint or creating the impression that the Complaint is without factual basis. If Defendant [X] breaches this agreement, the Commission may petition the Court to vacate the final judgment and restore this case to its active docket. Nothing in this provision affects Defendant [X’s] testimonial obligations or right to take legal positions in litigation in which the Commission is not a party.¹

This provision stems from the Commission’s desire to use its police (and public relations) powers to promote deterrence. Commission press releases regularly accompany enforcement actions as a means of identifying – and thereby deterring – conduct that the Commission deems to contravene the federal securities laws. This provision is designed, in part, to address situations where the Commission settles a case only to have the defendant or respondent take issue publicly with the legal or factual basis for the Commission’s action. The Commission and its Staff have long recoiled when reading a newspaper account of the settled action that quotes the defendant or his lawyer saying that the case had no merit and was settled to avoid the expense of protracted litigation.

As a consequence, the Commission insists that the above-quoted provision be included in every settlement. Moreover, the Commission polices and, on occasion, pursues defendants who make statements inconsistent with that provision. In several instances, the Commission has

¹ The Commission employs a similar provision in consents to orders in administrative proceedings.

responded to such denials by threatening to invoke or successfully invoking the contractual right it bestowed upon itself to petition the Court to vacate the consent judgment.²

Putting aside the Commission's rationale for this provision, defense lawyers recognize it as Commission policy and regularly counsel their clients to accept it as part of the overall settlement process. In doing so, practitioners have taken comfort from the fact that the provision, by its terms, is not intended to compromise the defendant's testimonial rights in later proceedings, at least those to which the Commission is not a party. Accordingly, that provision should not constrain a defendant who is called upon to testify, for example, in a securities fraud class action that tracks the Commission's allegations. Rather, the defendant should be able to testify truthfully even if her testimony directly or indirectly contradicts the Commission's allegations in the settled action.

The same should be true in the case of a defendant who, after settling a Commission case, is later called upon to testify in deposition or at the trial of another defendant in the same or a related action brought by the Commission. It seems obvious that the Commission and its Staff do not intend, by insisting on this standard provision, that the witness must either refuse to testify or testify falsely if the import of his/her testimony is to deny the allegations the Commission made in the settled action. Our recent experience with the Staff, however, has cast some doubt on a witness' ability safely to testify in the same or another Commission action where that testimony might constitute a "denial" of the Commission's prior allegations.

We recently completed a non-jury trial against the Commission Staff before a federal district court (decision pending). In that action, the Staff summoned as a witness the former Chief Financial Officer of a publicly held company. Both the company and this former CFO consented to the entry of final judgments of permanent injunction barring them from violating the anti-fraud provisions of the 1933 and 1934 Acts. The former CFO's consent included the standard provision prohibiting him from denying, directly or indirectly, the Commission's allegations.

On cross-examination, we elicited the reasons the former CFO settled with the Commission. The witness testified that he lacked the financial wherewithal and the stamina to fight the SEC and decided to settle because he was not required to admit the allegations. We then examined the witness at length about the underlying events.

The Staff must have perceived his testimony to be helpful to our client, because notwithstanding the existence of a cooperation agreement, the Staff asked for and was granted permission to treat the witness as hostile for purposes of re-direct. On re-direct, the witness

² In *SEC v. Angelos*, C.A. No. B96-834 (D. Md. March 20, 1996), for example, the Commission moved to vacate a consent agreement based on the defendant's denial of culpability; the motion was withdrawn after the defendant withdrew his denial. Lit. Rel. No. 14886, 1996 SEC LEXIS 1172 (April 22, 1996). In another settlement, *SEC v. Tyson*, C.A. No. 96-5150 (W.D. Ark. Oct. 8, 1996), the defendant made comments through a representative that the SEC construed as denying the complaint's allegations. To prevent the SEC from withdrawing its consent to the settlement, the defendant retracted the comments. Lit. Rel. No. 15115, 1996 SEC LEXIS 2856 (Oct. 9, 1996).

testified that he did not believe any false public statements had been made during the relevant period about the transactions in question. Obviously bothered by that testimony, the Staff then asked a series of questions (to which objection was made) in an effort to evoke an outright denial of allegations the Commission had made in its initial complaint against the witness. When challenged, the Staff attorney defended the questioning by alluding to the settlement provision described above and argued that the evidence was relevant because:

[the witness] signed an agreement with the SEC that he would not deny [the complaint's allegations] . . . If he does deny, then there is an opportunity by the Commission to reopen the settlement.

In trying to assess the relevance of the Staff's questions, the Court was particularly mindful of the witness' dilemma. The Court noted the Staff's threat to re-open the settlement if the witness answered improperly – *i.e.*, if he denied specific accusations the Commission had made in the complaint to which he consented. The Court then described the witness' Hobson's choice:

The consent decree says that Mr. [X] agrees that he will neither admit nor deny the allegations . . . Now you put him under oath and you say to him forget about the consent decree, let's throw that out. You're asking him to violate what he's agreed to at your request . . . What you are asking him to do is the very thing you told him he was not permitted to do.

The Court decided to permit a limited examination as to whether the witness was admitting or denying the allegations. Even then, the witness recognized that he was on a slippery slope:

What do you want me to say? I signed this agreement, I agreed to this agreement. So, I'm completely lost in your questioning.

The Court then limited the question to whether the witness still agreed to the terms of the settlement, a matter of little significance to our case.

This episode, however, illustrates the danger inherent in the language of the provision defendants and respondents must accept if they are to settle with the Commission. As the foregoing suggests, some members of the Staff evidently believe that the language in the consent – which carves-out proceedings in which the Commission *is not* a party – limits the witness' testimonial rights in proceedings in which the Commission *is* a party. We believe that such an interpretation is seriously strained and distorts the nature of the agreement reflected in these settlement provisions. Indeed, the standard settlement agreement for a settling defendant, like the one at issue in our suit, also contains a cooperation clause that requires the settling defendant to *testify truthfully*.

Although we do not question the Staff's motives, we believe the recent incident highlights an ambiguity with the language the Commission employs. In our case, one can only wonder what the Staff attorney expected the witness to do in the circumstances. Clearly, the Staff was disappointed with the answers the witness had given, but the fact remains that the



witness was under oath at the time (and said nothing that contradicted his prior testimony during the preceding Commission investigation). We have little difficulty assuming that the Staff would not countenance untruthful answers simply in the interests of having a witness “fulfill” a contractual bargain. At the same time, given the superior bargaining position of the Commission, a fearful witness examined in this fashion by a government attorney may be tempted to stray from the truth in a misguided attempt to escape further wrangling with the Commission over the vitality of the prior settlement.

The solution is a reasonably easy one – clean up, if not eliminate, the settlement provision to make it clear that the witness’ obligation to tell the truth trumps all else. In fact, we anticipate that various Staff members would defend the provision by saying it says just that. Nevertheless, in view of the Staff’s position at a recent trial, we recommend that defense counsel and their clients scrutinize this and other standard settlement provisions carefully and insist upon clarifications that reflect the parties true intentions.

For further information, please do not hesitate to contact any of the following C&M lawyers who specialize in SEC Enforcement and related matters.

Richard J. Morvillo
Pat Conti
Stephen M. Byers

Joseph I. Goldstein
Jeffrey F. Robertson
William M. Mann