Securities Litigation and Enforcement

Second Circuit Reverses Judge Rakoff, Sets Low Bar for Approval of SEC Settlements

By: Stephen L. Ascher, Christian R. Bartholomew, Larry P. Ellsworth, Thomas C. Newkirk and Joshua H. Rubin

Overview

In a long-awaited ruling, on June 4, 2014, the United States Court of Appeals for the Second Circuit reversed the November 2011 decision in which U.S. District Court Judge Jed Rakoff refused to endorse the SEC's settlement with Citigroup, holding that Judge Rakoff had abused his discretion. In a sweeping rejection of the district court's approach, the Court of Appeals made clear that federal courts may not substitute their judgment as to the substantive adequacy of an SEC settlement for that of the agency, nor may they demand that the SEC prove its allegations or extract admissions from the defendant. The Court of Appeals stressed that the role of the district court is limited to "ensuring that the consent decree is procedurally proper" and that, in so doing, district courts may not question the economic terms or factual aspects of the settlement. In connection with its holding that only a procedural review is appropriate, the Court of Appeals devised a four-part test to focus on the basic elements of a consent decree, *i.e.*, whether it is on its face legally proper, whether it provides for a clear enforcement mechanism, whether it resolves the claims in the complaint, and whether there was any collusion or corruption involved in obtaining the decree.

SEC Enforcement Director Andrew Ceresney greeted the ruling with satisfaction, saying in a statement that he was "pleased" that the Court of Appeals reaffirmed the "significant deference accorded" to the SEC in determining whether to settle with parties and on what terms.[1] At a recent Washington, D.C. bar meeting, Ceresney elaborated on this statement, saying that he agreed that court review should be limited because the SEC is in a much better position to assess whether the proposed settlement is appropriate, given its access to and knowledge of the extensive record developed in these matters. Ceresney also made clear that he did not think that application of the Court of Appeals' four-part test would present any meaningful obstacle to the SEC's efforts to settle matters through federal consent decrees. We think this conclusion is probably right, but that, at least initially, some district courts will apply the test to scrutinize SEC settlements more closely than they have historically done. Ceresney also said that he does not think that the Court of Appeals' decision will affect the SEC's forum choices going forward, *i.e.,* whether to bring litigated matters in federal court or in administrative hearings. In this vein, we note that even before the Court of Appeals' decision, senior SEC enforcement officials repeatedly stated that they intend to bring more actions in the administrative forum, a point Ceresney reiterated at the bar meeting.

I. The SEC's Settlement with Citigroup

The settlement arose from the SEC's October 2011 lawsuit against Citigroup Global Markets Inc., in which the SEC alleged that Citigroup had taken an undisclosed "short" position contrary to the interests of investors in an investment fund that Citigroup had structured and marketed.[2] The SEC's central allegation was that Citigroup had falsely represented to investors that an independent investment advisor had selected desirable assets for the portfolio, when, according to the SEC's complaint, Citigroup itself had selected assets that Citigroup projected were likely to lose value, to advance its short position.[3] The SEC alleged that Citigroup negligently misrepresented to investors its role and economic interest in creating the fund.

The proposed consent judgment resolving these claims included four main terms: 1) a permanent injunction enjoining Citigroup from violating Sections 17(a)(2) and (3) of the Securities Act, 15 U.S.C. § 77q(a)(2) and (3); 2) a requirement that Citigroup disgorge $160 million in net profits; 3) an assessment of prejudgment interest of $30 million; and 4) a civil penalty of $95 million.[4]

II. The District Court's Refusal to Approve the Settlement

On November 28, 2011, in a widely reported decision, U.S. District Judge Jed S. Rakoff refused to approve the proposed consent judgment because it was not "fair, reasonable, adequate, and in the public interest."[5] Judge Rakoff first held that the settlement failed to give the court or the public "some knowledge of what the underlying facts are."[6] By allowing Citigroup to enter into the consent decree without admitting or denying the underlying allegations, the SEC had, in Judge Rakoff's view, "deprive[d] the Court of even the most minimal assurance that the substantial injunctive relief it is being asked to impose has any basis in fact."[7] The district court also questioned the SEC's decision to bring a charge based on negligence rather than a charge involving allegations of scienter or fraudulent intent.[8] Finally, the district court ruled that the proposed $95 million civil penalty was inadequate, describing it as "pocket change to an entity as large as Citigroup."[9]

III. The Court of Appeals' Opinion

In a decision released on June 4, 2014, the Court of Appeals for the Second Circuit reversed. Although the Court of Appeals agreed at the most general level that the district court "is not merely a rubber stamp" for SEC settlements, the Court rejected several fundamental aspects of the district court's review.[10] The central distinction running through the opinion was that between a procedural versus a substantive review. Specifically, the Court held that the "primary focus" of the district court's review "should be on ensuring the consent decree is procedurally proper," meaning that a district court should satisfy itself that the SEC and the respondent have negotiated a genuinely adversarial settlement, but the district court should not undertake a substantive review of the economic terms or factual aspects of that settlement.[11]

Based on this distinction, the Court held that Judge Rakoff had erred in three basic respects:

- First, the Court held that Judge Rakoff erroneously concluded that the SEC settlement was inadequate because it did not serve the public interest in "knowing the truth."[12] Accordingly, the Court rejected any requirement that a district court make factual findings in approving a consent decree.[13] Rather, a district court need only establish that a "factual basis" exists for the proposed decree, a requirement that can be satisfied by factual averments that the defendant neither admits nor denies.[14]
- Second, the Court held that Judge Rakoff erred in considering whether the settlement assisted private plaintiffs challenging the same misconduct by providing those private plaintiffs with collateral estoppel benefits.[15] Accordingly, a district court should not consider whether an SEC settlement requires an admission of liability,[16] nor should a district court evaluate whether the SEC filed appropriate charges against the defendant, as that is an issue within the prosecutorial discretion of the governmental agency.[17]
- Finally, the Court held that Judge Rakoff should not have concluded that the SEC settlement was "inadequate" because it did not adequately punish the perpetrator, provide restitution for victims, or deter future misconduct by others.[18] The Court limited the "adequacy" requirement to the class action context from which Judge Rakoff had borrowed it, in which a court must protect the interests of absent class members (a concern not at issue in the

context of evaluating a consent decree between only two parties).

Although firmly holding that these three substantive issues are beyond the proper scope of a district court's review, the Court nonetheless acknowledged that a district court should review a proposed consent judgment to ensure that the agreement between the parties is procedurally fair and reasonable.[19] The Court identified four questions meant to guide such an assessment: 1) the basic legality of the decree; 2) whether the terms of the decree, including its enforcement mechanism, are clear; 3) whether the consent decree resolves the claims in the complaint; and 4) whether the consent decree is "tainted by improper collusion or corruption of some kind."[20] The Court placed particular emphasis on the last factor, suggesting specifically that, on remand, the district court could seek additional factual representations from the parties to dispel any concerns it has about improper "collusion or corruption."[21]

It is unlikely that this prong of the Second Circuit's test, which comes principally from the class action context, will have much effect on SEC settlements. Courts have refused to approve class action settlements on the ground of "collusion or corruption" when the named plaintiff received some special benefit above and beyond that received by the class.[22] In those instances, courts have held that the named plaintiff colluded with the defendant to the detriment of absent class members whose interests the court was obliged to protect. The only other circumstance where courts have found improper collusion is when a governmental agency settled claims without entering into a true adversarial negotiation with the defendant, because, for example, the government simply accepted recommendations from the defendant's expert without a real give-and-take.[23] This scenario also seems quite unlikely in the SEC enforcement context.

In an interesting coda, the Court ended its decision by observing that the SEC is under no obligation to file suit in federal court and may instead seek remedies through its own administrative proceedings.[24] The Court observed that the scope of relief available in administrative proceedings may be more limited than the relief available through a consent decree and federal court injunction, but that the price of accessing the broader array of remedies in federal court is some degree of judicial review.

Conclusion

The Second Circuit's decision is a resounding endorsement of the limited review of its settlements that the SEC has long sought and that it sought before Judge Rakoff. Although district courts may now subject SEC settlements to the structured four-part review announced by the Second Circuit, that review is unlikely to have any substantive effect on the SEC's settlements: except in truly unusual circumstances, those settlements will be approved.

Contact Us

Stephen L. Ascher, Partner, Jenner & Block

Co-Chair, Securities Litigation and Enforcement Practice

Phone: 212 891.1670 Email: sascher@jenner.com Download V-Card

Neil M. Barofsky, Partner, Jenner & Block

Co-Chair, Securities Litigation and Enforcement Practice

Phone: 212 891.1675 Email: nbarofsky@jenner.com Download V-Card

Thomas C. Newkirk, Partner, Jenner & Block

Co-Chair, Securities Litigation and Enforcement Practice

Phone: 202 639.6099 Email: tnewkirk@jenner.com Download V-Card

Howard S. Suskin, Partner, Jenner & Block

Co-Chair, Securities Litigation and Enforcement Practice

Phone: 312 923.2604 Email: hsuskin@jenner.com Download V-Card

Christian R. Bartholomew, Partner, Jenner & Block

Phone: 202 639.6040 Email: cbartholomew@jenner.com Download V-Card

Timothy J. Chorvat, Partner, Jenner & Block

Phone: 312 923.2994 Email: tchorvat@jenner.com Download V-Card

Larry P. Ellsworth, Partner, Jenner & Block

Phone: 202 639.6032 Email: lellsworth@jenner.com Download V-Card

Michael K. Lowman, Partner, Jenner & Block

Phone: 202 639.6018 Email: mlowman@jenner.com Download V-Card

J. Kevin McCall, Partner, Jenner & Block

Phone: 312 923.2686 Email: jmccall@jenner.com Download V-Card

Keith V. Porapaiboon, Partner, Jenner & Block

Phone: 312 840.7280 Email: kporapaiboon@jenner.com Download V-Card

Suzanne J. Prysak, Partner, Jenner & Block

Phone: 312 923.2915 Email: sprysak@jenner.com Download V-Card

---

[1] Statement on 2nd Circuit Decision, Andrew Ceresney, Director, SEC Division of Enforcement (June 4, 2014), *available at* http://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1370541993346#.U5imyOZ8Ncs (last visited June 11, 2014). 2 *SEC v. Citigroup Global Markets, Inc.*, 827 F. Supp. 2d 328, 329 (S.D.N.Y. 2011) ("Citigroup I").

[3] *SEC v. Citigroup Global Markets, Inc.*, Nos. 11-5227, 11-5375, 11-5242, 2014 WL 2486793, at *1 (2d Cir. June 4, 2014) ("Citigroup II").

[4] *Citigroup I*, 827 F. Supp. 2d at 330.

[5] *Citigroup I*, 827 F. Supp. 2d at 330.

[6] *Citigroup I*, 827 F. Supp. 2d at 332.

[7] *Citigroup I*, 827 F. Supp. 2d at 332.

[8] *Citigroup I*, 827 F. Supp. 2d at 330.

[9] *Citigroup I*, 827 F. Supp. 2d at 334.

[10] *Citigroup II*, 2014 WL 2486793, at *6 (internal quotation marks omitted) (emphasizing that a district court's evaluation of a proposed consent judgment should proceed from the "strong federal policy favoring the approval and enforcement of consent decrees").

[11] *Citigroup II*, 2014 WL 2486793, at *7.

[12] *Citigroup II*, 2014 WL 2486793, at *9. While the Court of Appeals agreed with Judge Rakoff that a district court must determine that the public interest "is not disserved" by a proposed consent decree that contains injunctive relief, it clarified that the SEC, as part of one of the public branches of government, is best positioned to assess the competing policy tradeoffs inherent in any determination that a consent decree is in the public interest. A district court therefore owes "significant deference" to the agency's determination on this score. *Id.*

[13] *Citigroup II*, 2014 WL 2486793, at *8.

[14] *Citigroup II*, 2014 WL 2486793, at *8.

[15] *Citigroup II*, 2014 WL 2486793, at *10.

[16] *Citigroup II*, 2014 WL 2486793, at *9 (reasoning, moreover, that such a determination is a discretionary matter of policy inappropriate for judicial review).

[17] *Citigroup II*, 2014 WL 2486793, at *10 (citing *United States v. Microsoft*, 56 F.3d 1448, 1459 (D.C. Cir. 1995) and *Heckler v. Chaney*, 470 U.S. 821, 831 (1985)). In so holding, the Court of Appeals reaffirmed the longstanding principle foreclosing judicial review of the exercise of prosecutorial discretion.

[18] *Citigroup II*, 2014 WL 2486793, at *7.

[19] *Citigroup II*, 2014 WL 2486793, at *7.

[20] *Citigroup II*, 2014 WL 2486793, at *7.

[21] *Citigroup II*, 2014 WL 2486793, at *8.

[22] *See, e.g.*, *Women's Comm. for Equal Employment Opportunity v. Nat'l Broad. Co.*, 76 F.R.D. 173, 180 (S.D.N.Y. 1977) ("[W]hen representative plaintiffs make what amounts to a separate peace with defendants, grave problems of collusion are raised."); *Wesley v. Spear, Leeds & Kellogg*, 711 F. Supp. 713, 720 (E.D.N.Y. 1989) (“If class representatives expect routinely to receive special awards in addition to their share of the recovery, they may be tempted to accept suboptimal settlements at the expense of the class members whose interests they are appointed to guard.”); *see also Plummer v. Chem. Bank*, 91 F.R.D. 434, 440 (S.D.N.Y. 1981) (describing the possibility of improper collusion in the class action context in light of the “inherent pressures upon plaintiffs’ counsel to act in harmony with the defendant in reaching a settlement, lest the defendant choose to negotiate with someone else and counsel lose the fees and prestige associated with appointment as attorney for the class”).

[23] *Compare United States v. Tulluride Co.*, 849 F. Supp. 1400, 1404 (D. Colo. 1994) *with United States v. Chevron, U.S.A., Inc.*, 380 F. Supp. 2d 1104, 1106 (N.D. Cal. 2005).

[24] *Citigroup II*, 2014 WL 2486793, at *10.