CORPORATE CRIME

‘Obey the Law’ Injunctions Questioned in Some Courts

A mainstay of settlements of SEC enforcement actions is an injunction against future violations of the relevant securities laws. In fact, for its first 50 years, the only remedy that the SEC could obtain against public companies was an injunction.

Originally, injunctions served as an effective tool in stopping ongoing securities frauds. In 1939, for example, an SEC official stated in a speech that the injunctive remedy was resorted to if the offense was ongoing. After the filing of the complaint, most injunctions were consented to, he said, and, in rare cases where defendants persisted in their unlawful conduct, the SEC had them cited for contempt.1 In the decades since then, the SEC began routinely asking courts to enter injunctions in litigated and settled cases, often when the allegedly fraudulent conduct had long ceased. The SEC’s recent action against Goldman Sachs is a prominent example of this established practice. In addition to seeking disgorgement and penalties from Goldman and Fabrice Tourre, the SEC asks the court to enjoin them both, based on conduct that occurred three years before the filing of the complaint. Courts in the Eleventh and D.C. circuits have raised serious questions about the propriety of the kind of injunction sought against Goldman, based on both the lack of specificity of the enjoined conduct and concerns about the constitutionality of follow-on contempt proceedings.

The standard SEC injunction orders a defendant to do only what the securities laws already requires it to do, namely obey the law. The value of such an injunction lies in the threat of contempt for violation of the order and its collateral effect on various aspects of the defendant’s business. An SEC injunction has, in other words, more bark than bite. As SEC Chairwoman Mary Schapiro observed in 2006, in the context of accounting scandals such as Enron, “[A]n injunction to simply go forth and sin no more is not an adequate response.” Chairwoman Schapiro, then vice chair of the NASD, added, “In order to really change behavior in certain components of the industry, on a going forward basis, the remedies just have to have more sting.” She made these comments on a panel of former and current regulators on enforcement remedies, convened by the SEC Historical Society.2

The prior year, an opinion by the Eleventh Circuit in October 2005, SEC v. Smyth, had created a stir in the defense bar—and the halls of the SEC.3 In a now infamous footnote, Judge Tjoflat writing for the panel, observed that the injunction entered by the court below was “unenforceable.”4

The defendant in Smyth had agreed to the entry of the injunction, resolving the issue of his liability for insider trading, and litigated only the amount of disgorgement he would pay. The injunction was not at issue in the appeal, the defendant having stipulated with the SEC that he waived any right to appeal it. The panel nevertheless spelled out constitutional arguments against “obey the law” injunctions, pointing to precedent in the Fifth and Eleventh circuits. According to the reasoning in the decision, the problem lies in the SEC’s ability to move the court issuing the injunction, in one state, for civil contempt of the “obey-the-law” injunction arising from conduct that could violate the securities laws, no matter where in the United States the alleged violation of the securities laws was committed. To use the example in Smyth, the commission could use the injunction to obtain personal jurisdiction in Georgia (where it would be otherwise lacking) for a violation committed in California, depriving the defendant of protection from the Due Process Clause of the Fifth Amendment.

The SEC moved for reconsideration of the Smyth decision, and asked the court to delete the footnote, as wrong, and unnecessary to its ruling.5 The motion was denied, the footnote stands, and the SEC has taken the position that it is dicta, which is erroneous and can be ignored.6 The SEC persists in presenting “obey the law” injunctions to courts for approval in settled actions, even in the Eleventh Circuit, where it has generally succeeded in having them entered.

A little-noticed decision by the Court of Appeals for the District of Columbia in a litigated case, SEC v. Washington Investment Network, 475 F.3d 392 (D.C. Cir. 2007), calls this practice into question. The court upheld an injunction entered by the

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taking on the SEC, combining the constitutional
Act. Judge Steven Merryday found that the
provisions of the Securities Act and Exchange
failed to answer the complaint. The SEC moved
an alleged “pump and dump” scheme, the defendant
23TBM (M. D. Fla. Apr. 22, 2010), which involved
of the specificity requirements of Rule 65(d). In
Support, the decision cites
which operated as a fraud or deceit upon any person.”
or course of business which operates or would
operate as a fraud or deceit upon any person.”
for its view that its injunctions do not have
limited to prevent repetition of
the conduct found to be unlawful, i.e. defrauding
and prospective clients. 519 F. Supp. 2d
at 81.

Despite Smyth and Washington Investment, the SEC has continued to seek what it chooses to
call “statute-based injunctions,” relying on
language in the Securities Exchange Act of 1934 and
decisions by numerous courts upholding
broad injunctions. The Exchange Act contains
two relevant provisions. One, §21(d), authorizes the
SEC to bring enforcement actions in federal
court to enjoin “acts or practices” that appear to
violate the statutes. The other, §21(e), authorizes the
SEC to apply to a federal district court for an
order “commanding any person to comply with
the provisions of this Act….” It is the second
provision, §21(e), that the Commission relies on
for its view that its injunctions do not have to meet
the specificity requirements of Rule 65(d).
(The Securities Act, Advisers Act and IC Act do not contain parallel provisions with the broad
grant of authority in Exchange Act 21(e), depriving the
SEC of this argument when they action is not
based on the Exchange Act.)

An Eleventh Circuit district judge has recently
taken on the SEC, combining the constitutional
arguments in the Smyth footnote with an analysis
of the specificity requirements of Rule 65(d). In
SEC v. Sky Way Global, Case No. 8:09-cv-455-T-
23TBM (M. D. Fla. Apr. 22, 2010), which involved
an alleged “pump and dump” scheme, the defendant
failed to answer the complaint. The SEC moved
for a default judgment and a permanent injunction
against violations of the registration and anti-fraud
provisions of the Securities Act and Exchange Act. Judge Steven Merryday found that the
circumstances warranted an injunction, but not of
the kind sought by the SEC. (The decision does not appear on the SEC’s Web site.)

The Smyth decision explains at length the
reasons and precedent supporting the conclusion
that conventional SEC injunctions do not comply
with FRCP 65(d). Since the injunction threatens
contempt for violation of its terms, he reasoned,
those bound by it should have explicit notice of
what conduct is outlawed, as should appellate
courts reviewing it. In support, the decision cites

"in any public relations
marketing endeavor...that misrepresents or
suppresses information concerning cigarettes.”

In a nod to this precedent, the SEC submitted a
revised proposed order to Judge Merryday in
the alternative with its brief for reconsideration.
The revised injunction is more narrowly tailored than
the original order, in line with the orders entered
in Philip Morris and Washington Investment. (The decision is pending.)

In light of the SEC’s approach in Sky Way, we can anticipate that the SEC will continue to assert
vigorously its right to “obey the law” injunctions in
federal court actions. Given that the SEC settles
over 90 percent of its actions, practitioners would do well to challenge the practice of “obey the law”
injunctions when they are negotiating settlements.

The trend of judges to scrutinize SEC settlements,
in this and other contexts, may persuade the SEC
Enforcement Division to present settled cases to
acquaint a friendlier audience, the commission itself, which has had the authority, since 1964 to issue cease and
desist orders for violations of the Exchange Act.
An “obey the law” cease-and-desist order would not have to comply with the Federal Rules of Civil Procedure, and could not be directly enforced by a
contempt action-either civil or criminal. Cess-
and-desist orders do have a significant collateral
effect under the securities laws, and should be an
attractive alternative to an agency that is focused
on using its resources efficiently and effectively.

Notably, SEC Commissioner Luis Aguilar, who
recognizes the need to maximize enforcement
resources in policing the markets with more potent,
surgical remedies, champions a number of existing
weapons in the SEC’s arsenal, such as penalties,
officer-and-director bars, and industry bars.7 One
remedy he omits from his list of effective deterren
t is the blunt instrument of the standard “obey the
law” injunction, which may one day be a thing of
the past.


6. For example, §42(d) of the IC Act authorizes the SEC to bring an action in district court “to enjoin such acts or practices
and to enforce compliance with this Act...”

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