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'Obey the Law' Injunctions Questioned in Some Courts

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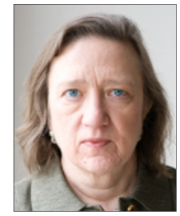

A mainstay of settlements of SEC enforcement actions is an injunction against future violations of the relevant securities laws. In fact, for its first 50 years, the only remedy that the SEC could obtain against public companies was an injunction.

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]

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JOURNALISTS STAKE out the **headquarters of Goldman Sachs in Manhattan** in April, shortly after the Securities and Exchange Commission accused the company of "defrauding investors" over subprime mortgage securities. Among other remedies, the agency is seeking an injunction directing Goldman to obey the law.

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."

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.[4] 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.[5] 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 court below following a bench trial, but found it insufficiently specific and not in compliance with Rule 65(d) of the Federal Rules of Civil Procedure, which requires that injunctions describe "in reasonable detail…the act or acts sought to be restrained." The order entered by the court stated simply that two of the defendants were enjoined from future violations of three provisions of the Investment Advisers Act of 1940.

Following remand on this issue to the district court, and extensive briefing, the district court issued an injunction far more specific than the prior one. *SEC v. Bolla*, 519 F. Supp. 2d 76 (D.D.C. 2007). The district court followed guidance from an early D.C. Circuit decision *SEC v. Savoy Industries*, 665 F.2d 1310, 1318-19 (1981). *Savoy* struck from an injunction as overbroad a command that the defendant not "engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person." Noting that *Savoy* overlapped with the specificity requirements of FRCP 65(d), the district court in *Washington Investment* approved an order that was narrowly tailored to prevent repetition of the conduct found to be unlawful, i.e. defrauding clients 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.)[6]

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 *Sky Way* 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 *Schmidt v. Lessard*, 414 U.S. 473, 476 (1974), for the proposition that because of the contempt sanction, "basic fairness requires that those enjoined receive explicit notice of precisely what conduct is outlawed."

Judge Merryday rejected an argument by the SEC that it was exempt from the requirements of FRCP 65(d) under Eleventh Circuit precedent, including *SEC v. Carriba Air,* 681 F.2d 1318 (1982), and invited the SEC to submit a revised order that enjoins specific acts and practices. As it had in *Smyth*, the SEC moved for reconsideration. Its brief in support, numbering 20 pages, vigorously defends the SEC's right to "obey the law" injunctions. Interestingly, the SEC brief does not refer to the D.C. Circuit decision, *Washington Investment Network*, which directly bears on the applicability of Rule 65(d) to SEC injunctions. Instead, the SEC relies on a civil RICO case brought by the government against cigarette manufacturers. That decision, *United States v. Philip Morris*, indicates the extent to which Rule 65(d) requires specificity in the framing of injunctions.

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 when they are negotiating settlements.

Philip Morris is illuminating on this issue. The injunction upheld by the D.C. Circuit was not, the Court found, "a generalized injunction to obey the law, especially when read in the context of the district court's legal conclusions and 4,088 findings of fact about fraud in the manufacture, promotion and sale of cigarettes." (The decision is being appealed.) The injunction upheld in *Philip Morris* enjoined false statements "in any public relations or 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 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. Cease-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 deterrents is the blunt instrument of the standard "obey the law" injunction, which may one day be a thing of the past.

1. Robert E. Kline, Jr., "Enforcement Work in the General Counsel's Office." (available in the SEC library in Washington, DC).
2. A transcript of the panel appears on the Web site of the SEC Historical Society.
3. See A. Strauss, "'Smyth' Decision Faults SEC's Use of Injunctions," NYLJ (Nov. 3, 2005).
4. See M. Aguilar, "SEC Asks Court to Reverse Ruling on Civil Injunctions," Compliance Week (Oct. 11, 2005).
5. See, e.g., *SEC v. Utsik*, 06-20975 (S.D. Fla.), Plaintiff's SEC's "Notice of Filing Consents…" available at http://entertainmentgroupinfo.com/images/document6.pdf.
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…."
7. Luis A, Aguilar, "Market Upheaval and Investor Harm Should Not Be the New Norm," May 24, 2010, Speech at Compliance 2010, available on the SEC's Web site.