The SEC's New 'Admit Liability' Policy Will Hurt Everyone Except Plaintiff Lawyers

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The Securities and Exchange Commission recently announced that it would no longer automatically allow companies to settle SEC investigations and lawsuits without admitting liability. According to an internal SEC memo explaining why "certain" companies will be treated differently, "there may be certain cases where heightened accountability or acceptance of responsibility through the defendant's admission of misconduct may be appropriate, even if it does not allow us to achieve a prompt resolution."

It's hard to argue with a regulatory agency seeking more flexible penalties for carrying out a regulatory mandate. But the approval with which SEC watchers generally greeted the policy may be premature, for it's not likely to further SEC enforcement objectives. On the one hand, this may little more than a cosmetically deft finesse of all the judicial and political pressure on the SEC to achieve better results in enforcement actions, especially those arising from the 2008 financial system collapse. If so, as even the SEC has suggested, most companies will continue to settle using the standard neither-admit-nor-deny formula, and the SEC's enforcement business will continue to be done pretty much as usual. But on the other hand, if the SEC requires more than a token number of companies to admit liability, the winners will not be the investing public but plaintiff class action lawyers.

Why? To start with, the new SEC policy was not an immaculate conception born solely of internal agency policy deliberations. In late 2011, in a highly publicized ruling, federal district Judge Jed S. Rakoff rejected the SEC's $285 million settlement of a lawsuit alleging that a Citigroup mortgaged-backed-securities fund had misrepresented its assets' risks to investors. The settlement did not require Citigroup to admit wrongdoing, and that, according to Judge Rakoff, meant that the settlement was "unsupported by any proven or acknowledged facts" and thus failed to provide a "framework" for determining the adequacy of the settlement, including whether it was in the public interest. Other judges emulated Rakoff, and then congressmen escalated criticism of the SEC's allegedly poor enforcement achievements. Incoming SEC chair Mary Jo White found herself under considerable pressure to respond to these critics. Hence the new policy (even though recently an appellate court, in a preliminary ruling, held that Judge Rakoff may have exceeded his authority).

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But the policy provides little guidance about which companies will have to admit liability as a price of settlement. According to the internal SEC memo, the policy will be applied to companies whose misconduct was especially widespread and harmful, particularly "when the defendant engaged in egregious intentional misconduct." But already under existing SEC policy, a company that admits wrongdoing in order to resolve a Department of Justice criminal investigation or proceeding must admit liability in any SEC settlement. In most cases, a company meeting the SEC's "egregious intentional misconduct" standard is likely to be criminally prosecuted and therefore to admit guilt as part of a resolution. To the extent that there are companies whose "egregious intentional misconduct" somehow escaped DOJ scrutiny, they will be outliers.

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But the SEC could come under considerable pressure to apply its policy to more than a token number of companies. Precisely because its standards are vague, the SEC may find it difficult to apply the policy fairly without applying it expansively. What constitutes "egregious intentional misconduct" is in the eye of the beholder, so distinguishing one company's egregious conduct from another's nonegregious conduct may not be easy. The SEC may discover that fairness and consistency require application of the policy to more than a token number of sacrificial companies.

The paradox is that the more widely the SEC applies the new policy, the fewer the benefits to investors will be, and the greater the damage to enforcement of the securities laws. The only real winners will be plaintiff class action lawyers, our modern day Robin Hoods, who, as the saying goes, steal from the rich and give half to the poor. Widespread application of the new policy will make their lives easier and their bank accounts fatter. Typically when a company pleads guilty to DOJ criminal charges involving harm to consumers or investors, or otherwise admits liability, plaintiffs' attorneys file a class action complaint within a day or two that consists of a civil caption and a text copied virtually word for word from the charging instrument. Since the company, by virtue of its admission, cannot contest liability, the lawsuit often resembles a damages inquest, in which companies have little leverage and the outcome is a substantial financial payment that will not benefit the majority of company shareholders. According to studies, only 20% to 35% of class members file claims in the typical securities class action settlement. The same will be true for companies forced by the SEC (but not the DOJ) to admit liability.

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A more than token application of the new policy means that more than a token number of companies will insist on fighting the SEC rather than being delivered to the tender mercies of the plaintiffs' class action bar with both hands tied behind their backs. Protracted and hard-fought litigations will drain resources from the SEC's overall enforcement program, especially enforcement proceedings against individual executives, which are most likely to deter securities violations. Cases will take years to resolve, which means that by the time a trial is over and the appeals exhausted, the events that gave rise to the case will be ancient history, and the responsible company executives, if not the entire management, will have long since moved on, eroding the original deterrent objective behind the SEC's lawsuit. And, of course, the costs of a final, non-appealable judgment obtained by the SEC ultimately will be borne by *all* of the company's shareholders, who will likewise ultimately bear the cost of resolution of the class action lawsuit. At a time when the Supreme Court is restricting class actions, in part to curb their potential for abusive settlements, the new SEC policy may do just the opposite.

A law enforcement policy applied only to a handful of companies is largely irrelevant. But a policy whose overall societal costs increase the more widely it is applied is inherently flawed. The SEC may come to regret its new policy.

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