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SEC Conduct — A Shield Against Enforcement

-- By James W. Thomas Jr. and Tom McSorley, Arnold & Porter LLP

Law360, New York (August 25, 2011) -- Two recent federal district court rulings offer an opportunity to consider two defense strategies that highlight the U.S. Securities and Exchange Commission's investigative, enforcement and litigation tactics and use them against it as a potential shield against enforcement.

The first case involves Mark Cuban, owner of the Dallas Mavericks, who has been embroiled in a high-profile insider trading action brought by the SEC.[1] As part of his defense, Cuban asserted that the SEC staff prejudged the outcome of its investigation into his trading and engaged in investigative misconduct through witness tampering and intimidation that warranted dismissal of the claims against him.[2] This equitable "unclean hands" defense was stricken by the district court.

In the second case, Rajat Gupta, a former McKinsey & Co. partner, was charged with providing nonpublic material information to Galleon Management LP. Of 28 individuals accused of Galleon-related wrongdoing, Gupta was the only one charged in an administrative proceeding in lieu of a federal court action.[3] Gupta challenged the SEC's decision to proceed administratively by filing a collateral action in the Southern District of New York alleging equal protection and due process violations.[4] After Judge Jed Rakoff held that Gupta's claims for constitutional violations could proceed, the parties mutually agreed to drop the SEC administrative action and Gupta's suit.

Equitable Defense Against SEC Enforcement

Equitable defenses go by many names, and their place in the law is, according to the late Justice Hugo Black, "older than the country itself."[5] In the securities context, "estoppel" and "unclean hands" are most frequently invoked. Defendants invoke one or both defenses against the SEC under similar, and reasonably common, circumstances and typically the defenses are unsuccessful.

A common thread among most claims of estoppel against the SEC is an assertion that the defendant was somehow misled by the government to its detriment. In SEC v. Des Champs, for example, a defendant claimed that the SEC provided "guidance regarding the appropriate accounting treatment of the type of transactions at issue," and thus was estopped from asserting that the defendant's behavior in compliance with such guidance was improper.[6]

Similarly, in SEC v. KPMG LLP, the defendants asserted that the SEC was estopped from bringing an enforcement action based on a failure to address certain accounting issues after a SEC enforcement staff member had given them the impression that all accounting issues meriting inquiry had been appropriately addressed.[7] Defendants have also asserted estoppel in a broader array of cases. In SEC v. Silverman, the defendants claimed estoppel because the SEC waited four years from a consent judgment against the defendants before filing a motion for disgorgement.[8]

And, in SEC v. Northern, a recipient of inside information from his consultant, who received it at a Department of Treasury press conference with a disclosure embargo, claimed estoppel because the government allegedly did not adequately enforce the embargo or refrain from posting the information on the web before the embargo was due to expire.[9]

Defendants in SEC actions regularly assert an unclean hands defense in conjunction with estoppel defenses in situations where the government has allegedly conducted itself improperly. For example, in Cuban, the SEC was accused of witness tampering and intimidation. Similarly, in KPMG, the defendants asserted that the same factors underlying the estoppel defense amounted to unclean hands.

Other examples of acts upon which unclean hands defenses have been based include the SEC's intertwining or coordinating enforcement actions with criminal investigations,[10] alleged altering of trial transcripts to remove evidence of improper statements by attorneys involved in a defendant's case,[11] purported breach of Canadian securities laws in a joint SEC-Ontario Securities Commission investigation by revealing confidential information to a private investigator,[12] and alleged knowing violation of a confidentiality order by obtaining a copy of a defendant's deposition in a separate action.[13]

Although the Supreme Court has avoided "a flat rule that estoppel may not in any circumstances run against the government," it has recognized "the Government may not be estopped on the same terms as any other litigant." Heckler v. Comty. Health Servs. of Crawford Cnty. Inc., 467 U.S. 51, 60 (1984).

Thus, courts have held the standard to assert equitable defenses against the SEC is higher than that necessary to assert defenses against private litigants. Courts have framed the requirements to assert equitable defenses against the government as requiring the "the most serious of circumstances" that demonstrate "egregious" misconduct by the SEC resulting in "extreme prejudice" that rises to the "constitutional level." See, e.g., SEC v. Musella, 38 Fed. R. Serv. 2d 426, 428 (S.D.N.Y. 1983); SEC v. Elecs. Warehouse Inc., 689 F. Supp. 53, 73 (D. Conn. 1988), aff'd 891 F.2d 457 (2d Cir. 1989).

Indeed, numerous district court cases have held categorically, as a matter of law, that the unclean hands equitable defense may not be invoked against the SEC because it is an agency which is attempting to enforce a congressional mandate in the public interest. See, e.g., SEC v. Rivlin, No. 99-1455 (RCL), (D.D.C. Dec. 20, 1999); SEC v. Condron, Civil No. B-85-87, (D. Conn. June 11, 1985); SEC v. Gulf & W. Indus. Inc., 502 F. Supp. 343, 348 (D.D.C. 1980).

Cuban and Unclean Hands

In his July 18, 2011, order, District Judge Sidney Fitzwater first considered the availability of the unclean hands equitable defense against the SEC in light of authority holding the defense unavailable against government action, including a decision in his own district holding unclean hands to be unavailable as a matter of law. See SEC v. Hayes, No. CA 3-90-1054-T, (N.D. Tex. July 25, 1991). Judge Fitzwater analyzed in detail prior decisions considering the issue, including the cases cited by Hayes, and came to the opposite conclusion, holding that "unclean hands" was an available defense against an SEC action.

Those prior decisions included Gulf & Western and United States v. Second National Bank of North Miami, 502 F.2d 535 (5th Cir. 1974), upon which Gulf & Western relied. Judge Fitzwater found nothing in Second National Bank's holding that suggested that unclean hands was categorically unavailable, as opposed to unavailable in that particular case. And, because Gulf & Western relied on Second National Bank for its assertion of an absolute bar to the unclean hands defense, Judge Fitzwater found Gulf & Western to be unpersuasive authority in light of the fact that the court in Heckler specifically refused to adopt a rule that equitable defenses could never be asserted against the government.

Ultimately, Judge Fitzwater rejected the authority cited by the SEC as based on a misinterpretation of precedent perpetuated through cases that merely "cite each other without explaining their reasoning."[14]

Although Judge Fitzwater found no absolute legal bar to asserting an unclean hands defense against the SEC, he articulated an exacting standard for establishing the defense. According to Judge Fitzwater, defendants must show that "[t]he SEC's misconduct [was] egregious," occurred before the filing of the action, and "result[ed] in prejudice to the defense of the enforcement action that rises to a constitutional level and is established through a direct nexus between the misconduct and the constitutional injury."[15]

He articulated both principled and practical reasons for requiring such an exacting standard. As a matter of principle, such defenses can limit the use of statutory injunctive relief as a law enforcement tool. As a

practical matter, equitable defenses "can easily become instruments to challenge, and thereby to effectively derail, the enforcement action" when the focus of the litigation shifts to the conduct of both the defendant and the SEC.[16]

Applying this standard, the court found Cuban had failed to plead facts of plausible prejudice to his defense of the action that rose to the level of a constitutional injury. The court rejected Cuban's assertions that alleged SEC manipulation or coercion of witnesses during the investigation prevented him from obtaining truthful evidence during the enforcement action. Accordingly, Judge Fitzwater dismissed Cuban's unclean hands affirmative defense.

The Cuban district court's requirement that prejudice from the SEC's alleged unclean hands must "rise to a constitutional level" is consistent with Heckler and the long line of authority that public policy generally trumps equity when government agencies (including the SEC) are enforcing the law.[17] Courts occasionally have permitted assertions of estoppel or unclean hands against the SEC to advance past the pleadings, so that a record may be developed to assess the defense.[18]

For example, in 2006, the District of Colorado refused to strike the defense of unclean hands in an SEC action against James Kozlowski, a former Qwest Communications accountant.[19] However, there appears to be no reported recent example of a defendant successfully quashing an SEC enforcement action simply by invoking an equitable defense. Thus, while equitable defenses remain available to defendants in SEC actions, the Cuban decision is a reminder that their viability is extremely limited, notwithstanding a defendant's belief that he or she was aggrieved by any part of the investigative process.

Gupta and Constitutional Considerations

Whereas in Cuban the district court expressed concern that focusing on the SEC's investigation tactics through equitable defenses could effectively derail an enforcement action, Gupta is a recent example of a defendant successfully using the SEC's litigation tactics to derail an enforcement action by framing what is effectively a quasi-estoppel argument as a constitutional due process/equal protection violation.

As mentioned above, Gupta was the only one of 28 individuals accused of Galleon-related wrongdoing to be targeted by the SEC in an administrative proceeding in lieu of a federal court proceeding. In his federal court collateral action, Gupta challenged this treatment by alleging constitutional equal protection and due process rights and related procedural safeguards such as the Seventh Amendment jury right. Gupta could have couched his claims in equity, alleging that he had been unfairly singled out

by the SEC.

Instead, he affirmatively and extensively pled his defense to the SEC administrative action on constitutional grounds in a separate suit. While the unique factual circumstances of Gupta's case do not track directly with most of the other situations defendants have sought equitable relief against the SEC, Judge Rakoff's ruling contains helpful language. He held Gupta's case could proceed because of a federal court's "unfailing duty to provide a forum for vindication of constitutional protections to those who can make a substantial showing that they have indeed been denied their rights."[20]

Time will tell whether the procedural device employed by Gupta — filing a collateral lawsuit — will find success in other factual contexts, but the strategic decision to frame the issue as a constitutional problem rather than as an equitable question was significant. Indeed, it contributed to the SEC and Gupta subsequently dropping their competing actions, although the SEC has reserved the right to bring an enforcement action in federal court.[21]

Practice Implications

Both the Cuban and the Gupta cases suggest that care should be given to developing and framing a defense based on the SEC's conduct. Given the stated requirement to prove constitutional injury to establish an equitable affirmative defense, as a practical strategic matter, it may be more fruitful to emphasize potential constitutional violations over the equities of a particular situation. For example, the Nacchio court's discussion of what facts might have supported Kozlowski's equitable defense allude to his apparent reliance on his Fifth Amendment grand jury right as grounds for barring a civil action that was intertwined with a criminal one.[22]

In other words, the constitutional implications of Kozlowski's defense appear to have given the court pause because it refused to strike the defense without further development of the facts. Where courts have explained that equitable defenses against the SEC are allowed, but difficult to maintain, their holdings also generally suggest that, in actuality, it is constitutional defenses that they are wary of disallowing without some factual development.[23] In brief, the SEC appears to get the benefit of the doubt in equity, but defendants may get the benefit of the doubt when they can describe a colorable constitutional claim.

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[1] Complaint, SEC v. Cuban, No. 3:08-CV-2050-D (N.D. Tex. 2008).

[2] SEC v. Cuban, No. 3:08-CV-2050-D, (N.D. Tex. July 18, 2011).

[3] Rajat K. Gupta, Securities Act Release No. 9192, Exchange Act Release No. 63995, Advisers Act Release No. 3167, Investment Company Act Release No. 29580, Administrative Proceeding File No. 3-14279, (Mar. 1, 2011).

[4] Gupta v. SEC, No. 1:11-CV-1900-JSR, (S.D.N.Y. July 11, 2011).

[5] Glus v. Brooklyn E. Dist. Terminal, 359 U.S. 231, 234 (1959).

[6] No. 2:08-CV-1279-KJD, (D. Nev. Sept. 21, 2009).

[7] No. 03 Civ. 671(DLC), (S.D.N.Y. Aug. 20, 2003).

[8] 328 F. App'x 601, 603 (11th Cir. 2009).

[9] 400 F. Supp. 2d 362, 363-64 (D. Mass. 2005).

[10] SEC v. Nacchio, 438 F. Supp. 2d 1266, 1287 (D. Colo. 2006).

[11] SEC v. Follick, No. 00Civ.4385KMW, (S.D.N.Y. Dec. 18, 2002).

[12] SEC v. Rosenfeld, No. 97 Civ. 167 (RPP), (S.D.N.Y. July 16, 1997).

[13] SEC v. Lorin, No. 90 Civ. 7461 (PNL), 1991 WL 576895, at *1 (S.D.N.Y. June 18, 1991).

[14] Cuban, 2011 WL 2858299, at *6.

[15] Id. at *8.

[16] Id. at *9.

[17] See, e.g., Heckler, 467 U.S. at 60 ("[T]he Government may not be estopped on the same terms as any other litigant."); Pauly v. USDA, 348 F.3d 1143, 1149 (9th Cir. 2003); Rojas-Reyes v. INS, 235 F.3d 115, 126 (2d Cir. 2000).

[18] See, e.g., Des Champs; SEC v. PacketPort.com, No. 3:05-cv-1747 (JCH), (D. Conn. Sept. 27, 2006); see also SEC v. Happ, 392 F.3d 12, 20 (1st Cir. 2004) (affirming trial court's refusal to estop SEC from presenting an argument at trial); SEC v. DiBella, 409 F. Supp. 2d 122, 135-36 (D. Conn. 2006) (denying defendant's motion for summary judgment based on estoppel).

[19] Nacchio, 438 F. Supp. 2d at 1287.

[20] Gupta, 2011 WL 2674840, at *9.

[21] Joint Stipulation of Dismissal, Gupta v. SEC, No. 1:11-CV-1900-JSR (S.D.N.Y. Aug. 8, 2011).

[22] Nacchio, 438 F. Supp. 2d at 1287 n.13.

[23] See, e.g., KPMG; Franklin v. SEC, 285 F. App'x 761, 761 (D.C. Cir. 2008).