

To Judge or Not To Judge: Stage Is Set In SEC v. Citigroup

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Many have called him a hero and advocate of truth. To others, his maverick ruling is a significant departure from established precedent.

On November 28, 2011, Judge Jed S. Rakoff from the U.S. District Court in New York rejected a proposed settlement by the SEC of a securities lawsuit against Citigroup for \$285 million.

In his order, Judge Rakoff repeatedly cited the SEC's complaint, which accused Citigroup of creating a billion-dollar fund in which it knowingly dumped mortgage-backed securities on misinformed investors. The SEC suit alleged Citigroup structured and marketed this fund as an attractive investment and even touted that the assets had been hand-picked by an independent advisor, but in reality Citigroup knew these assets had negative projections and it was Citigroup who selected them for this portfolio. Adding insult to injury, Citigroup took a short position on the very same holdings. By betting that the assets would perform poorly, Citigroup realized net profits of approximately \$160 million while, at the same time, investors who bought into their fund lost more than \$700 million.

Despite the serious accusations, the SEC asked Judge Rakoff to sign off on a consent judgment against Citigroup. Under the terms of the proposed settlement, though Citigroup would neither admit nor deny any wrongdoing, it would change its review and approval process for mortgage-related security offerings and also be enjoined from further violations. In addition, Citigroup would pay a total of \$285 million consisting of disgorgement of \$160 million, prejudgment interest of \$30 million and a civil penalty of \$95 million. This prompted Judge Rakoff to set a hearing to ascertain whether such a settlement is "fair, reasonable, adequate and in the public interest." To this end, the judge asked the SEC to respond to questions such as:

Why should the Court impose a judgment in a case in which the SEC alleges a serious securities fraud but the defendant neither admits nor denies wrongdoing?

What is the total loss to the victim's as a result of Citigroup's actions? How was this determined?

How was the amount of the proposed judgment determined?...What reason is there to believe this proposed penalty will have a meaningful deterrent effect?

Why is the penalty in this case to be paid in large part by Citigroup and its shareholders rather than by the "culpable individual offenders acting for the corporation?"

In response, the SEC argued that judicial review in these cases is both limited and deferential. In other words, a reviewing court is not to substitute its judgment for that of the parties or ask whether this is the best possible settlement that could have been obtained. Instead, the SEC argued a reviewing court should take a "deferential posture" to the agency's determination of what is fair, adequate and reasonable. The SEC also reversed its prior position by asserting that "the public interest" is not part of the applicable standard of judicial review, but even if it were, the Court should still defer to the agency's recommendations.

Apparently, Judge Rakoff did not take kindly to the SEC's arguments. In a scathing opinion, after describing the egregious nature of the SEC's charges, the judge noted:

"Although this would appear to be tantamount to an allegation of knowing and fraudulent intent ("scienter," in the lingo of securities law), the SEC, for reasons of its own, chose to charge Citigroup only with negligence, in violation of Sections 17(a)(2) and (3) of the Securities Act, 15 U.S.C. § 77(q)(a)(2) and (3)."

Judge Rakoff also flatly rejected the suggestion that "the SEC is the sole determiner of what is in the public interest." While acknowledging that the law requires substantial deference to the views of an administrative agency, he pointed out that the Court must still exercise its independent judgment and be satisfied that it is not being used as a tool to enforce an agreement that is unfair, unreasonable, inadequate, or in contravention of the public interest. And in this case, because the proposed settlement "does not provide the Court with a sufficient evidentiary basis to know whether the requested relief is justified under any of these standards," the Court refused to approve it, noting that it would not be a "mere handmaiden to a settlement privately negotiated on the basis of unknown facts, while the public is deprived of ever knowing the truth in a matter of obvious public importance."

Judge Rakoff also strongly critiqued the SEC's "long-standing policy – hallowed by history, but not by reason – of allowing defendants to enter into Consent Judgments without admitting or denying the underlying allegations..." Specifically, the judge noted that such settlements, coupled with only modest penalties, are "frequently viewed, particularly in the business community, as a cost of doing business imposed by having to maintain a working

relationship with the regulatory agency, rather than as any indication of where the real truth lies." Judge Rakoff further commented that in this case, "[i]f the allegations of the Complaint are true, this is a very good deal for Citigroup; and, even if they are untrue, it is a mild and modest cost of doing business." For these reasons, the judge seriously questioned what the SEC is getting from this settlement "other than a quick headline."

Accordingly, Judge Rakoff held that even after giving the fullest deference to the SEC's view, this proposed settlement, which "asks the Court to impose substantial injunctive relief, enforced by the Court's own contempt power, on the basis of allegations unsupported by any proven or acknowledged facts whatsoever, is neither reasonable, nor fair, nor adequate, nor in the public interest." To conclude otherwise and apply "judicial power that does not rest on facts is worse than mindless, it is inherently dangerous." Thus, instead of rubber stamping the settlement, the Court directed the parties to prepare for trial.

Not happy with this ruling, the SEC and Citigroup filed petitions and appeals to set aside Judge Rakoff's order, as well as an emergency motion to stay the pending trial in the underlying action and to expedite the SEC's appeal. On March 15, 2012, the motion panel for the Second Circuit Court of Appeal granted a stay of the lower court proceedings and also scheduled oral arguments on the appeal for this coming September.

While the motion panel's decision is not binding on the appellate panel that will ultimately decide the merits, in issuing the stay the panel did consider whether the SEC and Citigroup made a strong showing that they were likely to succeed on the merits. On this issue, the panel perceived several problems. Specifically, the opinion pre-judges that "Citigroup had in fact misled investors, and assumes that the SEC would succeed at trial in proving Citigroup's liability." Responding to the judge's criticisms of the SEC's settlement policy, the panel stated "it is not the proper function of the federal courts to dictate to executive administrative agencies what policies will best serve the public interest." Further, while it claimed to have given the "fullest deference" to the SEC's view, the panel observed that "there is no indication in the record that the Court in fact gave deference to the SEC's judgment on any of these questions." It thus concluded "it is doubtful whether the court gave the obligatory deference to the SEC's views in deciding that the settlement was not in the public interest." Finally, the panel questioned Judge Rakoff's view that the public interest is dis-served with "neither admit nor deny" settlements as requiring such an admission would in most cases "undermine any chance for compromise."

Despite the motion panel's decision, it is important to remember that the merits of the appeal have not actually been considered or decided. In fact, the appellate briefs have not even been submitted. Nevertheless, some commentators view the motion panel's decision as a precursor of what is to come.

Over the past few months, Judge Rakoff's ruling has sparked considerable debate over SEC consent judgments and the role of the judiciary in reviewing and confirming such settlements. At its core, the debate raises bigger questions about the judiciary's position in shaping public policy and highlights divergent perspectives on the issue. Based on the SEC's accusations against Citigroup, one can certainly understand why many people have sided with Judge Rakoff and his efforts to seek out the truth. Yet on a grander scale, unrestrained judicial activism can lead to greater instances of inequitable or inconsistent rulings and oftentimes blurs the line between our executive, legislative and judicial branches. The underlying debate on these issues will no doubt continue regardless of what happens to Judge Rakoff's ruling. In fact, when the appeals court chimes in later this year, we will likely hear even more comment and opinion on the subject.

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David J. Darnell is a senior attorney with Callahan & Blaine who specializes in complex business, contract and commercial matters, as well as disputes involving fraud and other intentional torts. Mr. Darnell and other attorneys at Callahan & Blaine have obtained outstanding results for clients in some of the most difficult and complex litigation matters. For example, Mr. Darnell recently obtained a \$15.5 million settlement for his client in a case involving claims of illegal dividends and breach of fiduciary duty against corporate officers and directors. For more information on Mr. Darnell and Callahan & Blaine, please feel free to visit the firm's website at www.callahan-law.com or call 714.241.4444.

