Advisory

AUGUST 2013

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SEC Requires Admission of Wrongdoing in Civil Settlement

In a sharp departure from longstanding practice, the Securities and Exchange Commission has required New York-based hedge fund adviser Philip A. Falcone and his advisory firm Harbinger Capital Partners to admit to wrongdoing as a condition of settling civil charges brought by the agency. As part of the settlement, which was announced on Monday, August 19, Falcone and Harbinger also agreed to pay more than $18 million in fines, disgorgement and interest and Falcone agreed to be barred from the securities industry for at least five years.

BACKGROUND

In June of this year, the SEC sued Falcone and Harbinger in two separate enforcement actions. In one case, *Securities and Exchange Commission v. Philip A. Falcone, et al.*,12-cv-5027 (PAC) (S.D.N.Y. June 27, 2012), the Commission alleged that Falcone and his advisory firm manipulated the price and availability of a series of distressed high-yield bonds in a "short squeeze" against a large investment firm later identified as Goldman Sachs Group, Inc. In the other case, *Securities and Exchange Commission v. Harbinger Capital Partners LLC,*12-cv-5028 (PAC) (S.D.N.Y. June 27, 2012), the Commission alleged that Falcone improperly used $113 million in fund assets to pay his personal taxes and favored certain investor redemption requests at the expense of other, smaller investors.

The settlement, which must be approved by the U.S. District Court for the Southern District of New York, requires Falcone to pay $6,507,574 in disgorgement, $1,013,140 in prejudgment interest, and a $4 million penalty. The Harbinger entities are required to pay a $6.5 million penalty. Falcone also consented to the entry of a judgment barring him from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization with a right to reapply after five years.

CHANGE IN POLICY

The Falcone and Harbinger settlements represent the first time the SEC has required an admission of wrongdoing as a prerequisite to settlement outside of the context of a pending, parallel criminal case. For decades the agency allowed defendants to settle civil and administrative cases without admitting or denying liability, a strong inducement for defendants to settle cases involving an agency that lacks the resources to try many cases.

The change in policy was first announced in June of this year by new SEC Chair Mary Jo White shortly after the Commission rejected a proposed settlement with Falcone and Harbinger under which neither would have admitted wrongdoing and Falcone would have been barred for only two years. According to White, the Commission had concluded that in "egregious" cases, an admission of wrongdoing would be required.

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SEC Requires Admission of Wrongdoing in Civil Settlement CONTINUED

DILEMMA FOR DEFENSE COUNSEL

The SEC's new policy raises difficult questions for defense counsel advising potential defendants regarding a possible settlement with the Commission. First and foremost, the admissions in a SEC settlement can have serious and far-reaching consequences, both civilly and criminally. "Egregious" cases are frequently referred to the Department of Justice for criminal prosecution and investors and shareholders possess the right to bring civil claims against potential defendants for money damages. Settling with the SEC prior to the expiration of the applicable statutes of limitation means subjecting the client to potentially far-reaching liability based on explicit admissions of wrongdoing. The Falcone/Harbinger settlement, for example, includes a 48-paragraph recitation of wrongful acts, including an admission that the defendants acted "recklessly." Reckless (or intentional) conduct is an essential component of a securities law claim.

Counsel with experience in criminal and civil securities cases know that the SEC and DOJ frequently work independently when it comes to resolving cases and overarching "global" settlements are often hard to come by, thereby increasing the uncertainty for clients interested in resolving the universe of claims against them. Some prosecutors will be influenced by a civil defendant's admission of liability and show reluctance to impose further on the judiciary's already limited resources or be perceived as overreaching. Others, however, will be emboldened to obtain an easy conviction erected largely, if not solely, on a defendant's own admissions. The lack of certainty when entering into a settlement with an admission component is therefore daunting.

The decision to settle is further complicated by the potential exposure for perjury. By denying wrongdoing under oath during SEC testimony and then admitting to such misconduct in a settlement is tantamount to admitting to perjury. Prosecutors could have a field day here.

Equally troubling is the open question of how frequently the SEC will insist on admissions of liability in its settlements. The conduct admitted to in the Falcone/Harbinger cases, while certainly fraudulent, is not uncommon. Further, what is egregious conduct today may be commonplace down the road. Perhaps the greatest impediment to the aggressive use of the new policy is the SEC's own limited budget, which effectively prevents it from expanding the number of cases it must litigate. An increase in the Commission's budget or a reallocation of resources, however, could easily eliminate this consideration and lead to a more robust use of the policy, even if it were to translate into more trials.

CONCLUSION

The SEC's settlement in the Falcone/Harbinger cases marks a dramatic – though not unexpected – departure from past Commission practice and ushers in an era of uncertainty and complexity not previously experienced. Practitioners whose clients are being investigated by the SEC now face a potential minefield of variables when negotiating settlements with the agency. Perhaps the greatest challenge will come in convincing the Commission that a client's conduct is not really "egregious" enough to mandate an admission of wrongdoing.

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