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Bifurcated Settlements: A New Approach To O&D Bars

Law360, New York (September 05, 2008) -- A new strategy has emerged for defendants facing the threat of an officer and director bar ("O&D bar") in an enforcement action by the Securities and Exchange Commission: enter into a bifurcated settlement that allows a judge to decide whether an O&D bar should be imposed.

To avoid an O&D bar, a defendant has traditionally faced a difficult choice: defeat the SEC on the merits or convince the SEC to abandon pursuit of the bar because evidence has changed. Both options present high burdens for defendants and carry substantial risk.

Settlements reached in three recent cases – McPike, Selden and Morano – have signaled a willingness by the SEC to resolve the applicability and appropriateness of an O&D bar in a new way.

Where a defendant and the SEC reach agreement on all issues except whether to impose an O&D bar, a bifurcated settlement can be entered into, leaving the court to decide whether an O&D bar is appropriate.

Background

An O&D bar is a form of injunctive relief. Pursuant to Section 21(d)(2) of the Exchange Act, a person may be barred – conditionally or permanently – from serving as an officer or director of any public company if the person violates an antifraud provisions of 15 U.S.C. § 78j(b) and displays "unfitness to serve as an officer/director." See 15 U.S.C. § 78u(d)(2). Whether a defendant is "unfit" turns on six factors:

(1) the egregiousness of the securities law violation;

(2) whether the defendant has previously violated securities law;

(3) the defendant's position when he engaged in fraud;

(4) the defendant's degree of scienter;

(5) the defendant's economic stake in the violation; and

(6) the likelihood that the defendant will commit future securities violations.

SEC v. Patel, 61 F.3d 137, 141 (2d Cir. 1995); see also SEC v. DiBella, D. Conn. 3:04-cv-1342, Ruling on Mot. for Final Judgment at 24-25, docket # 134 (Mar. 13, 2008) ("DiBella Ruling").

Although the list of factors to be considered is not exhaustive, predicting whether the defendant may commit other wrongful acts in the future is the primary focus of the analysis.

The courts enjoy "substantial discretion in deciding whether to impose a bar to employment in a public company," Patel, 61 F.3d at 141, and have demonstrated a willingness to adopt a fact-specific and highly individualized approach to the application of O&D bars.

Unlike courts, the SEC in recent years has been less willing to adopt an individualized inquiry and have instead followed a very formulaic method of imposing O&D bars. Since the beginning of 2007, the SEC has obtained approximately 120 O&D bars. Of those bars, 45 have been 5-year bars and more than 60 have been permanent bars.

While the remaining handful of bars were imposed for terms of various durations, half were set by courts after adjudication on the merits. The pattern is clear: if you attempt to negotiate a settlement with the SEC on an O&D bar, you essentially face only two options – a 5-year bar or a permanent bar.

The SEC appears to be unwilling to tailor a bar to the specific facts and circumstances of each case. This approach effectively sets a national standard – which is an important goal of the Enforcement Division – and a tough settlement position helps the SEC avoid any criticism that a wrongdoer was too easily returned to corporate America.

However, for defendants hoping to negotiate a resolution, the SEC's standardized position on O&D bars has served in many cases as a substantial deterrent to settlement.

Until recently, a defendant wishing to challenge the SEC's standardized approach to O&D bars had only two options, neither of which were particularly appealing.

First, a defendant could try to defeat the SEC on the merits. In the event that a defendant who chooses this option does not prevail through motion practice, he or she faces a monumental task at trial. Indeed, in the last few years, the SEC has had trial success rates of over 90%.

And while a defendant found liable by a jury may subsequently convince a court that an O&D bar is inappropriate, such a victory may be a pyrrhic one at best as the jury's finding of liability will follow the defendant throughout the remainder of his or her career – a constant and unshakeable shadow.

Second, a defendant could litigate the case through discovery and then try to convince the SEC that evidence has changed such that an O&D bar is no longer a warranted part of any resolution.

However, the change in evidence typically required would have to be so significant as to justify the abandonment of the SEC's fraud charge altogether (e.g., witness unavailability or substantial adverse evidentiary rulings from the court).

To succeed, a defendant needs to tackle the difficult task of putting the SEC's trial team in a position to credibly prove to its internal audiences, including the Commission, that the staff's initial recommendations on charges and remedies should be discarded in lieu of a more lenient approach.

An unsuccessful run at this approach leaves a defendant back in the position of having to proceed to trial or accept settlement on unfavorable terms.

New Approach

McPike, Selden, and Morano offer new strategies for practitioners negotiating settlements with the SEC whose clients face O&D bars – the bifurcated settlement. Admittedly, a bifurcated settlement is not a new or novel concept.

However, such agreements have traditionally concerned only disgorgement amounts; applying them to O&D bars is a new approach.

In McPike, Selden and Morano, the SEC filed a complaint against the each defendant alleging a violation of Section 10(b) and other securities laws. See SEC v. Competitive Technologies, Inc. et al., D. Conn. 3:04-cv-1331; SEC v. Selden, D. Mass. 05-11805; See SEC v. Lumenis, Ltd. et al., S.D.N.Y. 06-cv-3225.

Specifically, McPike involved allegations of market manipulation, Selden involved allegations of disclosure fraud by the CEO of a biotechnology company, and Morano involved alleged revenue recognition fraud by a CFO of a public company.

After reaching an agreement with the government, the defendant in each case consented to an entry of final judgment against him, but reserved the issue of whether an O&D bar should be imposed for the Court to decide.

The bifurcated settlements entered into in all three of these cases share a number of common provisions, which balance the SEC's and the defendant's positions:

– As with most settlements, the defendants consented to the entry of final judgment "without admitting or denying the allegations of the Complaint" – unquestionably, a benefit to defendants.

– The defendants also agreed to the entry of Final Judgments containing various equitable and financial terms, including injunctions, the payment of a civil penalty and/or disgorgement – a benefit for the SEC.

– The question of whether an O&D bar would be imposed was expressly reserved for resolution by the court – another benefit for defendants.

– In connection with resolution of the O&D bar, defendants agreed that the allegations of the Complaint would be deemed true and further agreed not to deny that a violation of the securities law occurred – an advantage for the SEC.

See Competitive Technologies, D. Conn. 3:04-cv-1331, Final Judgment, docket # 234 (Oct. 31, 2007); Selden, D. Mass. 05-11805, Consent to Judgment, docket # 63 (July 2, 2008); Lumenis, S.D.N.Y. 06-cv-3225, Consent to Final Judgment, docket # 35 (Aug. 8. 2008).

The court has now fully resolved the McPike matter, ultimately ruling that no bar should be imposed. In its decision issued from the bench, the court discussed the various factors governing "unfitness."

For example, the court considered the defendant's "repeat offender" status to be "zero," and stated that although the defendant was the top executive at the company, his role in the alleged violations was not the most important.

Hearing Trans. at 56-57 (Apr. 8, 2008). The court also concluded that the "degree of scienter [was] not terribly high," and that the defendant "chose not to advance himself economically when given the opportunity to in effect benefit from his plan." Id. at 58.

Finally, in evaluating whether the defendant's misconduct would reoccur, the court concluded that "it is extremely unlikely that [the defendant] would have the opportunity to engage in any conduct such as was charged here and I also think it is extremely unlikely he would do it again ... I find a likelihood of his conduct to recur to be close to nil." Id. at 59-60.

At the time of press, the courts in Selden and Morano had not yet resolved whether to impose an O&D bar on the defendants.

Moving Forward

There seems to be good reason for the SEC to continue to expand the use of the bifurcated settlement approach to resolving O&D bars.

Such settlements allow the SEC to obtain its desired relief without expending the full resources required for trial.

When the court decides whether to impose an O&D bar, the SEC benefits from the defendant being unable to challenge the allegations of the Complaint or deny that a securities law violation occurred.

This reduces the amount of evidence that the SEC needs to present at trial to prove its case.

Additionally, by settling all issues except the O&D bar, the SEC guarantees itself that it will obtain most of the relief it has sought – injunctions, civil penalties, and/or disgorgement.

Defendants should also welcome the ability to avoid the risk of a judicial determination of liability by entering into a settlement on a "neither admit nor deny" basis, while at the same time having the O&D bar issue decided by a court willing to engage in an individualized review.

Practitioners considering this approach should first conduct an evaluation of the likelihood of success in challenging the SEC's request for an O&D bar.

Whether a defendant can prevail depends upon the application of the factors governing "unfitness." Practioners should focus on whether they will be able to establish that:

– There is little or no risk of repeated misconduct by the defendant;

– Any misconduct was limited in contrast to the defendant's lengthy and otherwise distinguished career;

– The defendant did not profit personally from the misconduct;

– The misconduct occurred long ago and that the defendant has since fully complied with all securities laws; and

– Limited evidence exists of intentional wrongdoing or scienter on the part of the defendant.

Of course, if it is likely that a court will impose an O&D bar given the particular facts of the case, the question becomes whether a defendant can nonetheless convince an impartial fact -finder to impose a bar of shorter duration than the bar sought by the SEC.

When negotiating a bifurcated settlement, practitioners should also discuss with the SEC:

(1) modifying the complaint to include any favorable rulings made in the course of litigation;

(2) the ability to conduct discovery, especially if a settlement agreement is entered before the defendant has had an opportunity to conduct his or her own investigation into the issues surrounding an O&D bar;

(3) establishing the outer limit on the length of the bar the SEC will seek; and

(4) whether the parties will agree to let the court resolve the issue of an O&D bar on the basis of written submissions alone or if an evidentiary hearing is warranted.

Conclusion

As a practical matter, bifurcated settlements provide a new and attractive opportunity for defendants to challenge the applicability of the O&D bar without risking a negative ruling on liability and without undertaking the monumental and unlikely task of convincing the SEC to abandon its initial course of action.

Defendants should welcome the ability to enter into settlements without having to admit or deny liability, while an impartial fact-finder resolves the ultimate issue of the bar on an individualized basis.

Even if a bar is imposed, the court may impose a bar that is shorter in duration than the bar sought by the SEC. Even more critical, any bar would not be accompanied by a formal finding of liability after trial on the merits.

This approach also seems to make sense for the SEC, as it will maximize its ability to obtain the desired relief while minimizing the expenditure of resources to do so.

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