

# Client Alert

Latham & Watkins Litigation Department

## SEC's Use of Broad Civil Injunctions Attacked in the Eleventh Circuit

The Securities and Exchange Commission has a formidable enforcement record. During the SEC's last fiscal year which ended September 30, 2004, the SEC filed a total of 639 enforcement actions and obtained a record amount of more than \$3 billion in penalties and disgorgement.<sup>1</sup>

The overwhelming majority of those cases were filed as settlements, where the defendant or respondent consented to the entry of the relief imposed. The Commission's recent results in litigation have been mixed, however. The SEC has recently suffered several setbacks in federal district court including, for example, the dismissal of the first litigated case charging violations of Regulation FD.<sup>2</sup>

Last month, in a surprising development at the appellate level, the Court of Appeals for the Eleventh Circuit went out of its way to challenge the Commission's use of its basic remedy in federal court: broad civil injunctions that require the defendant to obey the law. In *SEC v. Richard P. Smyth, et al.*,<sup>3</sup> the Eleventh Circuit declared, in language that is almost certainly dictum, that such broad injunctions are too vague to be enforceable. The *Smyth* decision is of particular interest because, not only was the enforceability of the injunction not squarely before the Court, but it also follows another Eleventh Circuit decision last year

reversing a district court for its failure to issue just such an injunction.<sup>4</sup>

### The Eleventh Circuit's Decision in *Smyth*

The *Smyth* decision arises out of an SEC enforcement action filed in 2001 in which the SEC sued, among others, Arnold E. Johns, Jr., who served at various times as both president and chief financial officer of a public company, Vista 2000, Inc.<sup>5</sup> In June 2001, the SEC charged Johns, two other former officers and the outside auditor of Vista 2000 with violations of the anti-fraud, periodic reporting, recordkeeping, and internal accounting controls provisions of the securities laws.<sup>6</sup> For relief, the Commission sought from all defendants the usual remedies in such cases: an injunction against future violations, disgorgement of ill-gotten gains, and a civil money penalties.

After some discovery, the defendants, including Johns, entered into settlements with the SEC. Pursuant to those settlements, Johns and the other defendants entered into a stipulation that provided for the entry of permanent injunctions. The Commission and the defendants agreed to let the district court determine the amount of disgorgement or the return of illegal profits.<sup>7</sup> The settlement provided for an "Order of Permanent Injunction" which

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contained sweeping injunctive provisions that enjoined Johns from future violations of the securities laws cited in the SEC's complaint. Pursuant to the settlement, the district court entered the injunction, and upon the SEC's motion, the court entered a judgment against Johns for disgorgement and prejudgment interest.<sup>8</sup> Johns appealed, challenging the district court's failure to convene an evidentiary hearing prior to determining the amount of disgorgement.

On appeal, the Eleventh Circuit vacated the district court's order and remanded the case, holding that the court abused its discretion by entering judgment without holding an evidentiary hearing. The court sent the case back to the trial court for a hearing on the appropriate disgorgement. Although the enforceability of the injunction was not before the court, the court of appeals questioned — in a footnote — the enforceability of overbroad injunctions commonly used by the SEC, like the one issued against Johns. This footnote is dictum — the enforceability of the injunction was not before the court — but some commentators are questioning whether the court's decision may have important consequences for the future of the SEC's enforcement program.

## **The SEC's Use of Civil Injunctions**

When the SEC files an enforcement action in federal court, it invariably seeks an order that enjoins a defendant from future violations of the federal securities laws and regulations. Such injunctions are broadly worded to bar a defendant from violating specific statutes and regulations — as opposed to prohibiting a *specific act* under those statutes or regulations. For example, an injunction in a typical insider trading case will enjoin the defendant from any future violations of section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder rather than merely enjoining the defendant from

future insider trading. The SEC intends these broad civil injunctions to deter future securities law violations by recidivist offenders who might otherwise evade the technical prohibitions of a more narrow injunction.<sup>9</sup>

Historically, an injunction was the most important form of relief available in federal court to the SEC.<sup>10</sup> The Insider Trading Sanctions Act of 1984, the Securities Enforcement Remedies and Penny Stock Reform Act of 1990, and the Sarbanes-Oxley Act of 2002, have given the SEC a broad range of remedies.<sup>11</sup> For example, in federal court, the SEC may also seek civil monetary penalties or disgorgement, bar or suspend an individual from serving as a corporate officer or director, or even require various actions, such as audits, accounting for frauds, or special supervisory arrangements.

Nonetheless, the SEC continues regularly to seek civil injunctions because, once issued by a court, the injunctions facilitate the SEC's ability to seek sanctions against repeat offenders. This is particularly true where disobedience of the order is punishable as a contempt of court. In a judicial contempt proceeding, the SEC can more easily seek, and a court may impose, civil monetary (fines) or even criminal sanctions (imprisonment) for subsequent violations.<sup>12</sup> According to the SEC, it filed 21 contempt proceedings for violations of prior injunctions in 2004, the lowest total in five years.<sup>13</sup> Entry of an injunction can also have substantial collateral consequences for a defendant.<sup>14</sup>

## **What is the Effect of the *Smyth* Decision?**

In most contexts, appellate courts typically will not countenance overbroad, non-specific injunctive orders.<sup>15</sup> Under Federal Rule of Civil Procedure 65(d), an injunctive order must “be specific in terms” and “describe in reasonable detail . . . the act or acts sought to be restrained . . . .” Rule 65 serves to protect those who are

enjoined “by informing them of what they are called upon to do or to refrain from doing in order to comply with the injunction.”<sup>16</sup> Under Rule 65(d), therefore, every civil injunction must fairly apprise a party enjoined of the precise conduct that will risk contempt.<sup>17</sup> The *Smyth* court affirmed this principle.

In *Smyth*, the Eleventh Circuit challenged the SEC’s use of a broad injunctive order enjoining Johns from violating certain securities statutes, stating in a footnote that such “‘obey the law’ injunctions are unenforceable.” The *Smyth* court, citing Rule 65(d), noted:

[a]n injunction must be framed so that those enjoined know exactly what conduct the court has prohibited and what steps they must take to conform their conduct to the law.

The *Smyth* court specifically stated that the SEC’s use of “obey the law” injunctions are unenforceable because they violate a defendant’s due process rights. The court recognized that such injunctions permit the SEC to bring a future case by filing a contempt proceeding in the district where the injunction was issued — regardless of whether the defendant would otherwise be subject to personal jurisdiction in that district. Moreover, the court noted that a contempt proceeding would deny the defendant the rights he or she would receive if the SEC had to file a new case, including the rights afforded a civil litigant under the Federal Rules of Civil Procedure and the right to a jury trial guaranteed by the Seventh Amendment.<sup>18</sup>

The Eleventh Circuit’s dictum attacking broad, “obey the law” civil injunctions in *Smyth* is difficult to reconcile with an earlier decision by this same court reversing, as an abuse of discretion, a district court’s denial of such an injunction in *SEC v. Scott K. Ginsburg*.<sup>19</sup> In *Ginsburg*, the district court refused to enjoin permanently a corporate principal from future Securities Exchange Act violations after a jury had found him liable for communicating to

family members information about pending acquisitions by his company. The Eleventh Circuit reversed the denial of an injunction, stating that the SEC need only “show a reasonable likelihood that [the defendant] would violate the securities laws in the future” to be entitled to injunctive relief.<sup>20</sup> On remand, the district court issued a Final Judgment permanently enjoining Ginsburg from, *inter alia*, violating Section 10(b) of the Exchange Act.<sup>21</sup> The contrasting *Ginsburg* and *Smyth* decisions leave the Eleventh Circuit with confused precedent regarding the enforceability of the SEC’s use of broad civil injunctions.<sup>22</sup>

The SEC is said to be studying the *Smyth* decision, and the opinion has prompted speculation that the SEC will now design more specific injunctions with operative commands capable of enforcement.<sup>23</sup> The decision is unlikely to affect “obey the law” civil injunctions prohibiting future violations of securities laws or regulations that are already specific in scope (*e.g.*, prohibitions against making false filings under Rules 13a-1 and 13a-13 of the Securities Exchange Act). Civil injunctions tracking the broad statutory language of the securities antifraud laws<sup>24</sup> are more vulnerable to the type of criticism leveled in the *Smyth* decision.

The *Smyth* decision may cause some to suggest that the SEC use consent decrees that do more than merely cite a statute or regulation, but that are narrowly tailored to prohibit *specific acts* under the securities antifraud laws, like insider trading or operating a Ponzi scheme. It seems unlikely that the SEC will agree to such an approach, however, in view of its long-established use of broad civil injunctions. Whether a primary weapon used by the SEC to combat violations of the securities antifraud laws — enforcing broadly-defined civil injunctions through a contempt proceeding — is truly in jeopardy awaits further litigation, which will reveal whether other federal courts follow the dictum of *Smyth*.

**Endnotes**

- <sup>1</sup> U.S. SEC 2004 PERFORMANCE AND ACCOUNTABILITY REPORT 25, available at <http://www.sec.gov/about/secpar/secpar04.pdf>; see also Kip Betz, *SEC Enforcement: SEC's Market Reviews 2004 Enforcement Activities*, Securities Law Daily (BNA) (Sept. 14, 2005).
- <sup>2</sup> *SEC v. Siebel Systems, Inc.*, — F.Supp.2d —, 2005 WL 2100269 (S.D.N.Y. Sept. 1, 2005) (dismissing the SEC's complaint that Siebel Systems, Inc. violated Regulation FD). See also *SEC v. Morris*, — F.Supp.2d —, 2005 WL 2000665 (S.D. Tex. Aug. 18, 2005) (dismissing the SEC's aiding and abetting claim against Gary Morris, former CFO of Halliburton); *SEC v. Lucent Technologies Inc.*, — F.Supp.2d —, 2005 WL 1206841 (D.N.J. May 20, 2005) (dismissing several SEC claims against a former officer of Lucent for inadequate pleading).
- <sup>3</sup> *SEC v. Richard P. Smyth, et al.*, — F.3d —, 2005 WL 1884184, n.14 (Aug. 10, 2005).
- <sup>4</sup> *SEC v. Scott K. Ginsburg*, 362 F.3d 1292 (11th Cir. 2004). Latham & Watkins LLP represented the Appellant in that case.
- <sup>5</sup> *Smyth*, 2005 WL 2100269 at \*1.
- <sup>6</sup> See SEC Litigation Release No. 17044 (Jun. 21, 2001), available at <http://www.sec.gov/litigation/litreleases/lr17044.htm>.
- <sup>7</sup> The Commission will occasionally agree to this procedure when the only impediment to settlement is the amount a defendant will be required to pay. See, e.g., *SEC v. Mohn*, No. 02-74634, 2005 WL 2179340 (E.D. Mich. Sept. 9, 2005) (setting disgorgement after settled injunctive order entered).
- <sup>8</sup> See SEC Litigation Release No. 18607. (Mar. 3, 2004), available at <http://www.sec.gov/litigation/litreleases/lr18607.htm>.
- <sup>9</sup> See generally KIRKPATRICK & LOCKHART LLP, SECURITIES ENFORCEMENT MANUAL: TACTICS AND STRATEGIES 136-37 (ABA) (1997) (“The Commission therefore tends to seek an injunction when it believes the violation is likely to be repeated, reflects deliberate wrongdoing or other serious misconduct, or may require a remedy that is not available in an administrative proceeding.”).
- <sup>10</sup> See Thomas J. Andre, Jr., *The Collateral Consequences of SEC Injunctive Relief: Mild Prophylactic or Perpetual Hazard*, 1981 U. ILL. L. REV. 625 (1981).
- <sup>11</sup> See generally Stephen M. Cutler, Director, Division of Enforcement, Speech at the 24th Annual Ray Garrett Jr. Corporate & Securities Law Institute (Apr. 29, 2004), available at <http://www.sec.gov/news/speech/spch042904smc.htm>.
- <sup>12</sup> The unenforceability of judicial contempt orders founded upon an decree that is too vague to be understood was underscored by the Supreme Court in *International Longshoremen's Association Local 1291 v. Philadelphia Marine Trade Association*, 389 U.S. 64, 76 (1967) (“The judicial contempt power is a potent weapon. When it is founded upon a decree too vague to be understood, it can be a deadly one.”)
- <sup>13</sup> See SEC 2003 ANNUAL REPORT 17 (42 contempt proceedings filed in FY 2003); SEC 2002 ANNUAL REPORT 2 (47 contempt proceedings instituted in FY 2002, 31 instituted in FY 2001, 36 instituted in FY 2000, and 29 instituted in FY 1999).
- <sup>14</sup> See generally Andre, note 10, *supra*.
- <sup>15</sup> See, e.g., *Hughey v. JMS Development Corp.*, 78 F.3d 1523, 1531 (11th Cir. 1996); *Epstein Family Partnership v. KMart Corp.*, 13 F.3d 762, 771 (3d Cir. 1994); *Payne v. Travenol Labs., Inc.*, 565 F.2d 895, 897-98 (5th Cir. 1978). But c.f. *U.S. v. Miller*, 588 F.2d 1256, 1261 (9th Cir. 1978) (enforcing an “obey the law” injunction that tracked the language in the Interstate Commerce Act case where “the language standing alone state[d] a clear prohibition”).
- <sup>16</sup> 11A Alan Wright, Arthur R. Miller & Mary Kay Kane, *Federal Practice and Procedure: Civil 2D* § 2955 (1995 & Supp. 2005).
- <sup>17</sup> *Schmidt v. Lessard*, 414 U.S. 473, 476 (1974) (per curiam) (“[B]asic fairness requires that those enjoined receive explicit notice of precisely what conduct is outlawed.”)
- <sup>18</sup> *Smyth*, 2005 WL 1884184, n.14.
- <sup>19</sup> 362 F.3d 1292, 1304-05 (Mar. 2004).

<sup>20</sup> The standard that the SEC must meet for entry of an injunction in an enforcement action has long been the subject of some debate. See, e.g., Marc I. Steinberg, *SEC and Other Permanent Injunctions — Standards for their Imposition, Modification and Dissolution*, 66 CORNELL L. REV. 27, 32-41 (1981).

<sup>21</sup> Final Judgment Against Scott K. Ginsburg, *SEC v. Ginsburg*, No. 99-8694/RYSKAMP/VITUNAC (S.D. Fla. Jun. 4, 2004).

<sup>22</sup> Please note that Eleventh Circuit Chief Judge Edmondson was on appellate panels in both *Smyth* and *Ginsburg*, and that he dissented, in part, in *Ginsburg*.

<sup>23</sup> See generally Deborah Solomon, *Moving the Market: Court Ruling May Prompt SEC To Alter Its Use of Civil Injunctions*, WALL ST. J., Aug. 25, 2005, at C3.

<sup>24</sup> In *Affiliated Ute Citizens of Utah v. U. S.*, the Supreme Court stated that the antifraud provisions of the securities laws “are broad” and “are obviously meant to be inclusive.” 406 U.S. 128, 151 (1972).

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