

Asserting The 5th During SEC Investigations

Law360, New York (August 2, 2011) -- When any witness appears before the U.S. Securities and Exchange Commission to be examined during an SEC investigation, they are likely to be warned by a staff attorney that an adverse inference can be drawn against them if they assert their Fifth Amendment privilege.

The warning also usually informs the witness that the adverse inference may be drawn not only in the investigative stage at the SEC, but also in any subsequent legal proceeding brought by the SEC. This second warning has always struck me as questionable.

Ever since *Baxter v. Palmigiano*, 425 U.S. 308 (1976), the law has been clear that in a civil case, an adverse inference can be drawn against a party who asserts the Fifth Amendment privilege in that case. *Baxter* focused on the tension between two conflicting notions: (1) silence is often evidence of guilt; and (2) the Fifth Amendment protects the innocent as well as the guilty.

In resolving this tension, the court wrote:“(f)ailure to contest an assertion ... is considered evidence of acquiescence ... if it would have been natural under the circumstances to object to the assertion in question.” *Id.* at 425 U.S. at 319, quoting *United States v. Hale*, 422 U.S. 171, 176 (1975).

One could argue with some force that when there are parallel SEC and criminal investigations pending, it is “natural under the circumstances” not to testify until the criminal investigation is over. This suggests that the assertion of the Fifth Amendment under such circumstances would have little probative value, since guilty and innocent people might be expected to assert the Fifth Amendment under such circumstances.

(This raises all kinds of delicate attorney-client privilege issues, as one of “the circumstances” surrounding the assertion of the Fifth Amendment might be that the witness’ attorney advised him/her that, until the attorney had a better understanding of the facts and the scope of criminal investigation, even if the witness was innocent, it would have been reckless to testify).

Since *Baxter* was decided in 1976, there have been myriad cases in which defendants have asserted their Fifth Amendment privilege in a civil case, and later changed their minds and testified (or wanted to testify) in that same case — particularly near the end of discovery or at trial. See, e.g., *Gutierrez-Rodriguez v. Cartagena*, 882 F.2d 553 (1st Cir. 1989).

These cases generally focus not on the issue of the probative value of the earlier assertion of the Fifth Amendment, but rather on the unfairness of allowing a defendant to force the plaintiff to “conduct discovery and prepare his case without the benefit of knowing the content of the privileged matter.” *SEC v. Graystone Nash Inc.*, 25 F.3d 187, 191 (3d Cir. 1994). Of course, this rationale would only apply

when the defendant asserts the Fifth Amendment in the same case in which he/she later wants to testify.

Less clear is whether an inference can be drawn against a party who asserts the Fifth Amendment privilege only during the investigation or in a different case, but testifies fully when he/she is sued later. It is not uncommon for a witness to assert the Fifth Amendment during the SEC investigative phase because of concern that criminal authorities will use that testimony in a potential criminal case.

In many of those instances, however, the threat of criminal prosecution either disappears or becomes remote. In that event, the witness may change his/her mind and decide to testify fully in a civil action brought by the SEC.

One might expect to find many cases that deal with this situation, however, there are relatively few published opinions on this issue, and the opinions that do exist do not contain much scholarly discussion on this question. In *SEC v. Cassano*, No. 99 CIV. 3822(LAK), 2000 (S.D.N.Y. Oct. 11, 2000), Judge Lewis Kaplan allowed the SEC to argue the negative inference to the jury where the defendants asserted the Fifth Amendment during the SEC investigation, but subsequently waived the privilege in that action.

Without citing to any authority, Judge Kaplan wrote (albeit in a footnote): “The fact that this occurred some time ago and that these witnesses subsequently have waived the privilege in this action goes to the weight of the inference, not to the propriety of drawing it.” *Id.* at *2 n.1.

Four years later, Magistrate Judge Michael Dolinger in the Southern District of New York also allowed a negative inference to be drawn in an SEC case from the fact that the parties had invoked their Fifth Amendment privilege during the course of the SEC’s investigation. See *SEC v. Herman*, No. 00 CIV. 5575(PKC)(MHD), 2004 (S.D.N.Y. May 5, 2004).

Judge Dolinger wrote: “Although these individuals later testified in deposition in this case, their prior use of the Fifth Amendment privilege — which defendants do not even attempt to reconcile with their later testimony — is relevant to our inquiry.” *Id.* at *7.

The only case cited by Judge Dolinger for this proposition was Judge Kaplan’s opinion in *Cassano*, which, as described above, did not cite any authority for drawing the negative inference where the defendant testified in the subsequent SEC enforcement action.

Three years later, Judge Ellen Burns in the District of Connecticut wrote an opinion that had a more extensive discussion of the issue. See *SEC v. DiBella*, No. 3:04 CV 1342(EBB), 2007 (D.Conn. May 8, 2007). Judge Burns ruled that the SEC was entitled to argue the negative inference, but the only SEC cases cited by Judge Burns were *Cassano* and *Herman*.

The factors on which Judge Burns relied were: (1) the trial court has broad discretion in this area, (2) defendant’s prior assertion of the privilege during the investigative stage “both prevented and postponed necessary fact-finding, and ... the postponement affected Defendant’s memory, as well as provided him the opportunity to use Plaintiff’s discovery in the case as a roadmap to fashion his later testimony,” (3) defendant had ample warning of the SEC’s intention to seek an adverse inference if the defendants asserted the Fifth Amendment privilege, and (4) the timing of defendant’s waiver afforded him with an unfair “strategic advantage.” *Id.* at *3-4.

The only reported case going the other way was decided four months after *DiBella* by Judge Paul Cassell in the District of Utah. See *SEC v. Freiberg*, No. 2:05 CV 00233(PGC), 2007 (D.Utah Sept. 12, 2007). In

that case, citing only *Baxter v. Palmigiano* on the issue of the adverse inference, Judge Cassell declined to draw such an inference from the defendant's assertion of the privilege against self-incrimination during the SEC investigative stage.

While acknowledging that "courts may, but are not required to, draw an adverse inference where a defendant who refuses to testify during an investigation later testifies in discovery," Judge Cassell found that the defendant "responded to all questions at a later deposition and testified at the trial," and that "the SEC has not established it suffered prejudice from [the defendant's] early invocation of his Fifth Amendment Privilege." *Id.* at *10.

Taken as a whole, these cases raise more questions than they answer. For example, couldn't the SEC argue in virtually all of these cases that the assertion of the privilege during the investigative stage "prevented and postponed necessary fact-finding" until such time as the defendant testified in the subsequent civil case? After all, a "necessary fact" in virtually every SEC fraud case is the state of mind of the defendant, about which the defendant is uniquely qualified to testify.

Another relevant question is whether the same analysis would apply to a defendant who asserted the Fifth Amendment privilege in an investigation by a different regulator and then testified fully about the same subjects when sued by the SEC. Would the SEC be entitled to a negative inference in that case? If not, why not?

The courts' inclination to allow the drawing of the negative inference where the defendant asserted the privilege in the SEC's investigative stage, but fully testified when sued by the SEC, may be explained as an attempt to "level the playing field" by prohibiting a defendant from unfairly "gaming" the system. *SEC v. Graystone Nash Inc.*, *supra*, 25 F.3d at 193.

This is particularly true when the defendant's waiver of the Fifth Amendment privilege occurs after discovery is complete or nearly so. However, if the defendant complies with all of his/her discovery obligations throughout the enforcement action brought by the SEC and testifies freely in that case from beginning to end, is it accurate to say that the defendant unfairly "gamed" the system by originally asserting the privilege during the investigative stage?

A useful analogy can be drawn between the scenario we have described and a situation where a person asserts the Fifth Amendment privilege in testimony before Congress and then, when sued at a later point by a private party, fully testifies. Such was the case in *Fujisawa Pharmaceutical Co. Ltd. v. Kapoor*, No. 92 C 5508, 1999 (N.D.Ill. July 21, 1999).

There, the court stated that the rule "permit[ting] adverse inferences to be drawn against parties 'when they refuse to testify in response to probative evidence offered against them'" in civil actions "impli[ed] ... that this rule applies to Fifth Amendment invocations that take place in the proceeding at hand, not in a separate proceeding." *Id.* at *9.

Therefore, the plaintiff was precluded from arguing the adverse inference against the defendant because his "invocation of the Fifth Amendment came ... during a congressional hearing that was prior to and separate from the instant case. Further, the questions put to [the defendant] during that hearing are not 'evidence' within the meaning of *Baxter*. Moreover, [the defendant] was deposed at length by [plaintiff] in the instant case. Hence, [plaintiff] is not disadvantaged by being 'unable to obtain discovery.'" *LaSalle Bank Lake View v. Seguban*, 54 F.3d 387, 390 n.4 (7th Cir. 1995). *Id.*

Similarly, in *Metzler v. Vandergrindt*, 254 N.J. Super. 278, 603 A.2d 182 (Sup.Ct. 1991), a defendant in a

wrongful death action arising out of a car accident declined to be interviewed by a police officer investigating the accident. Later, when the defendant was sued by the injured party, he testified fully.

The court held that the plaintiff would not be allowed to argue that an adverse inference could be drawn against the defendant based on his early failure to answer a police officer's questions: "This court holds that the admission of evidence in a related civil lawsuit that a party exercised the Fifth Amendment privilege when questioned by the police for the purpose of having the jury draw an adverse inference against that party tends to abridge and perhaps even destroy the privilege. This is especially true in the circumstances of this civil case in which the defendant has not asserted the Fifth Amendment privilege at any stage of the civil proceedings." *Id.* at 281.

In sum, in the future, when the SEC is investigating alleged wrongdoing at the very time that criminal authorities are reviewing the same facts, we should expect to see defendants continuing to assert their Fifth Amendment privilege during the investigative stage, only to fully testify when the prosecuting authorities decline to prosecute. When that happens, we can anticipate more fully developed case law, at which point, the pendulum should swing to the defendant's side.

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