



## The SEC's Unconstitutional Conditions Doctrine?

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A new commentary by Crow & Cushing, the SEC's Unconstitutional Condition, examines a lawsuit challenging the constitutionality of the SEC's practice of prohibiting defendants who settle civil charges with the SEC from making any public statement, even an indirect one, which takes issue with the validity of the SEC's charges.

According to one study, the SEC settles 98% of the civil actions it institutes. In order to induce defendants to settle, the SEC customarily permits those defendants to say in the consent order that they neither admit nor deny the SEC's allegations. In other words, the SEC does not require that you admit wrongdoing, but you can't deny it either.

On January 9, 2019, the Cato Institute, a libertarian think tank, filed an action in Federal Court in the District of Columbia challenging the SEC's practice. The Institute, it tells us, has contracted with an author who was sued civilly by the SEC, consented to a settlement which bars public statements critical of the SEC's practices and its lawsuit and, therefore, cannot publish his book. Then author, at least for now, must remain anonymous because of the settlement agreement he (or she) signed.

In a private dispute between private parties, a prohibition against disparaging an adverse litigant is perfectly proper and indeed commonplace—it is commonly referred to as a “non-disparagement clause.” The government, on the other hand, is bound by the First Amendment and may curb freedom of expression only where the state has a compelling interest to do so, such as in the case of child pornography.

The question which the Cato Institute's case squarely projects is whether the consent of those that the SEC settles with to waive their constitutional right to free speech in exchange for the benefits the settlement affords them permits the government to do what the First Amendment otherwise forbids: to curb critical comments.

The question calls for application of a constitutional principle known as the "unconstitutional conditions doctrine," under which the government may not exploit someone's need for a benefit by conditioning the benefit on the waiver of a constitutional right. The Crow & Cushing paper concludes that the application of the rule to the SEC's conduct, while novel, is warranted. In other words, the Cato Institute is onto something.

The SEC's Unconstitutional Condition

As a condition of settling civil charges, the Securities and Exchange Commission (“SEC”) normally permits those it sues to say in a consent order that they neither admit nor deny the

SEC's allegations. But that's not as big a break for some litigants as it seems, because the SEC also has a rule that bars those litigants from making any public statement, even an indirect one, which takes issue with the validity of the SEC's charges.<sup>1</sup>

In other words, the SEC does not require you to admit wrongdoing, but you can't deny it either. You can't be blamed if you find this confusing, and perhaps unsatisfying. Maybe you want to know what the SEC is up to.

The regulation arose out of the SEC's willingness in its consent orders to permit defendants to neither admit nor deny the allegations. This was desirable for defendants, who would otherwise be put at a disadvantage in a later civil action as a result of their admission of wrongdoing, and made it easier for the SEC to settle cases and ensure a steady stream of income from the settlements.

The problem, at least from the SEC's perspective, was that by 1972, as soon as courts had signed off on the settlements, the defendants would commence public campaigns denying the SEC's allegations and claiming that they settled simply to avoid protracted litigation with the government. The SEC's answer was the rule barring public comment on the SEC's allegations.<sup>2</sup>

One past target of the SEC, who has so far remained anonymous because of the regulation, wrote a book to tell his (or her) side of the story. The catch is that the author can't publish the book for the same reason he (or she) remains anonymous -- the SEC's rule.

The Cato Institute, a libertarian think tank, contracted with that author to publish the book, but claimed it could not do so because of what Cato called the "Gag Regulation" and what it described as a "perpetual gag order" in the author's settlement with the SEC. That may be overstating it a bit. Nothing bars Cato from publishing the book. It is the author who is at risk.

In any event, Cato has filed suit on its own behalf asking the Court to rule that the SEC regulation is unconstitutional under the First Amendment because it restricts speech the amendment protects.<sup>3</sup>

Apart from the unusual circumstances of the case, what the SEC has asked this author to do is not unusual. According to the Cato Institute's complaint, the SEC settles approximately 98% of the cases it institutes.<sup>4</sup> Under those settlements, the SEC routinely prohibits litigants who enter into consent orders from claiming that the SEC's allegations aren't true, since all of those settlements are subject to existing SEC policy.

Unlike governmental attempts to restrict speech, those who settle lawsuits in the private sector have a free hand. In a private dispute between private parties, a prohibition of deprecating language about an opponent, often included in settlement agreements and referred to as a non-disparagement clause, is perfectly proper and indeed commonplace.

The government's attempt to limit constitutional rights is on a different footing. Given the importance of the First Amendment, the state may only curb freedom of expression where it has a compelling interest to do so, such as in the case of child pornography.

In its regulation, the SEC describes its interest to be preventing the litigant from creating "an impression that a decree is being entered or sanction imposed, when the conduct alleged did not, in fact, occur." That interest does not appear to be a particularly compelling one, especially where the target of the SEC's enforcement proceeding has been permitted to settle without

admitting or denying guilt, and there even appears to be a public interest which the regulation disserves: Don't we have the right to know whether the SEC's charges are true?

Contrast this with the federal government's practice in accepting guilty pleas to criminal charges. The United States Department of Justice will accept a guilty plea without an admission of guilt only in the most unusual circumstances.

While he was not asked to rule on the validity of the SEC's "gag orders," one federal judge regarded it as skeptically:

[H]ere an agency of the United States is saying, in effect, "Although we claim that these defendants have done terrible things, they refuse to admit it and we do not propose to prove it, but will simply resort to gagging their right to deny."<sup>5</sup>

The question which the Cato Institute's case squarely projects is whether the consent of those the SEC settles with – after all, they sign a "consent order" – to waive their constitutional right to free speech in exchange for the benefits a settlement affords them permits the government to do what the First Amendment otherwise forbids. Put another way, can a government restriction in a settlement agreement that otherwise violates constitutional rights be justified by the consent of the defendant to the restriction?

The answer may lie in a principle of constitutional law known as the "unconstitutional conditions doctrine." Under it, the government may not exploit someone's need for a benefit by conditioning the benefit on the waiver of a constitutional right.<sup>6</sup> Since the state cannot directly restrict an individual's constitutional rights absent a compelling reason, it should not be permitted to do so indirectly by granting a governmental benefit only upon the waiver of such rights. This is so even though there is no entitlement to the benefit, and it may be denied for any number of reasons. For example, the state cannot condition unemployment benefits on one's willingness to work on her Sabbath<sup>7</sup> or deny public employment based on political affiliation.<sup>8</sup>

Today, the government exercises power not only by adopting laws, but increasingly by entering into contracts. The consent order between the SEC and the would-be author is a form of contract. The SEC should not be able to restrain the author's freedom of expression through a contract any more than it can do so by law.