UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF FLORIDA
WEST PALM BEACH DIVISION
CASE NO.: 19-cv-80633-ROSENBERG/REINHART

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

v.

NATURAL DIAMONDS INVESTMENT CO., ET AL.,
_____/

PLAINTIFF SECURITIES AND EXCHANGE COMMISSION'S MOTION TO STRIKE RELIEF DEFENDANT GOLD 7'S FIFTH AFFIRMATIVE DEFENSE OF UNCLEAN HANDS PURSUANT TO RULE 12(f)(1)

I. INTRODUCTION

Relief Defendant Gold 7 is a party to this case on the limited claim that it possesses diamonds and other property that are the proceeds of the fraud alleged in the Complaint, to which it does not have a legitimate claim. Gold 7 has raised an affirmative defense of unclean hands, claiming that the Securities and Exchange Commission "knew about the alleged Ponzi scheme in 2018, yet took no actions to stop it, thereby allowing Gold 7 to purchase diamonds from Aman that it now claims were stolen," and failed to notify "the Department of Law Enforcement." [D.E. 77 at p.30].

Because this affirmative defense arises from the Commission's conduct in investigating enforcing the federal securities laws, an unclean hands defense can only lie if the Commission's conduct amounts to egregious misconduct, if the misconduct actually prejudiced Gold 7's ability to defend itself in this action, and if the misconduct has caused constitutional injury to Gold 7. Not only do Gold 7's allegations fail to rise to the level of misconduct, let alone the level of egregiousness that might implicate constitutional deprivations, but Gold 7 has also failed to demonstrate how its defense in this matter has been prejudiced as a result of any misconduct. Accordingly, this affirmative defense fails as a matter of law, and the Court should exercise its authority under Federal Rule of Civil Procedure 12(f)(1), which empowers the Court to strike an affirmative defense at any time.

Rule 12(f)(1) allows the Court to strike affirmative defenses and other parts of the pleadings at any time. That time should be now. Gold 7 is now seeking discovery concerning the affirmative defense.[1] Among other things, the Relief Defendant seeks evidence concerning the Commission's non-public investigation. The discovery requests will result in discovery litigation and the expenditure of significant resources by the Commission and the Receiver, and thus the expenditure of victim funds in the receivership. Tragically, this would all be for naught because no matter how much discovery is taken concerning the unclean hands affirmative defense, it fails as a matter of law.

II. THE COURT CAN STRIKE AN AFFIRMATIVE DEFENSE AT ANY TIME

The Court has the power under Rule 12(f)(1) to strike improper affirmative defenses, *sua sponte,* regardless of the passage of time from the filing of the pleadings. This is because Rule 12(f)(1) provides the Court with a mechanism to "clean up the pleadings, streamline litigation and avoid unnecessary forays into immaterial matters." *Sun Microsystems, Inc. v. Versata Enterprises. Inc.*, 630 F. Supp.2d 395, 402 (D. Del 2009) (quoting *Mclnernev v. Mover. Lumber & Hardware, Inc.*, 244 F. Supp.2d 393, 402 (E.D. Pa. 2002)). "[T]he authority given the court by the rule to strike an insufficient defense on its 'own initiative at any time' has been interpreted to allow the district court to consider untimely motions to strike and to grant them if doing so seems proper." *F.T.C. v. Instant Response Sys., LLC,* No. 13 CIV. 00976 ILG, 2014 U.S. Dist. LEXIS 17148, at *4-5 (E.D.N.Y. Feb. 11, 2014) (*quoting* Charles Alan Wright & Arthur R. Miller, Federal Practice And Procedure § 1380 (3d ed. 2004)).

As set forth below, there are no questions of fact or of law that could allow the unclean hands affirmative defense to be successful as pleaded. The Commission and receiver will be prejudiced by the inclusion of this defense. On October 7 and 9, 2019, Gold 7 issued substantial discovery requests to the Commission and Receiver, seeking information and evidence concerning the unclean hands defense. This includes discovery requests concerning the Commission's nonpublic investigation. If allowed, the unclean hands defense will lead to irrelevant, prolonged, and intrusive discovery concerning the Commission's investigation, and will also result in

[1] The remainder of the "affirmative defenses" Gold 7 pled are all simply denials of the Complaint allegations and are not affirmative defenses. Striking them merely because they are mislabeled would seem to put form over substance since any defendant or relief defendant can deny the Complaint's allegations, and there is no harm to Plaintiff or the Receiver by the mislabeling. Accordingly, we do not seek to strike them.

litigation concerning Gold 7's discovery requests. The prejudice to the Commission, the Receiver, and the victims whose funds in the receivership will be used to pay the costs of the Receiver's litigation concerning the discovery requests, coupled with the deficiency of the defense itself, is sufficient to warrant the defense being stricken. *SEC v. American Growth Funding II, LLC*, 2016 WL 8314623 (S.D.N.Y. Dec. 30, 2016) (striking unclean hands defense on Commission motion filed after the Rule 12(f)(1) deadline because the unclean hands defense was deficient and the defendant had sought discovery of the Commission concerning this defense).

III. GOLD 7'S UNCLEAN HANDS AFFIRMATIVE DEFENSE MUST BE STRICKEN

Motions to strike defenses are generally not favored. *Poston v. American President Lines, Ltd.*, 452 F. Supp. 568, 570 (S.D. Fla. 1978) (Such motions "will usually be denied unless the allegations have no possible relation to the controversy and may cause prejudice to one of the parties.") (citing *Augustus v. Board of Public Instruction*, 306 F.2d 862 (5th Cir. 1962)). However, courts will strike affirmative defenses where "the defense (1) has no possible relation to the controversy, (2) may cause prejudice to one of the parties, or (3) fails to satisfy the general pleading requirements of Rule 8 of the Federal Rules of Civil Procedure." *Tsavaris v. Pfizer, Inc.*, 310 F.R.D. 678, 680 (S.D. Fla. 2015).

"[I]t is equally true that generally, motions to strike are granted when the doctrine of unclean hands has been asserted against a government agency carrying out its congressionally mandated duties." *SEC v. Kirkland*, 2006 WL 844839 at *1 (M.D. Fla. Sept. 6, 2006) (internal citations omitted). *See also Martin v. Nationsbank of Georgia, N.A.*, No. 92-cv-1474, 1993 WL 345606, at *5 (N.D. Ga. Apr. 6, 1993); *United States v. S. Motor Carriers Rate Conference*, 439 F. Supp. 29, 52 (N.D. Ga. 1977); *SEC v. Gulf & Western Indus., Inc.*, 502 F. Supp. 343, 348 (D.D.C. 1980) ("[T]he doctrine of unclean hands ... may not be invoked against a governmental agency which is attempting to enforce a congressional mandate in the public interest."); *SEC v. Keating*, 1992 WL 207918 at *1 (C.D. Cal. July 23, 1992) (granting sanctions against defendant for pleading frivolous affirmative defenses against the Commission); *SEC v. Electronics Warehouse, Inc.*, 689 F. Supp. 53, 73 (D. Conn. 1988) (equitable defenses against the government are strictly limited), *aff'd sub nom.*, *SEC v. Calvo*, 891 F.2d 457 (2d Cir. 1989), *cert. denied*, 110 S. Ct. 3228 (1990).

"To the extent an affirmative defense such as unclean hands is available, it is only in strictly limited circumstances where the agency's misconduct is egregious, and the misconduct results in

prejudice to the defense of the enforcement action that rises to a constitutional level and is established through a direct nexus between the misconduct and the constitutional injury." *SEC v. Cuban*, 798 F. Supp. 2d 783, 795 (N.D. Tex. 2011) (internal citations omitted). *Accord*, *SEC v. Rosenfeld*, No. 97-1467, slip op., 1997 WL 400131, at *2 (S.D.N.Y. July 16, 1997) (Unclean hands may be asserted against the Commission only where "the agency's misconduct [was] egregious and the resulting prejudice to the defendant r[o]se to a constitutional level.") (quoting *SEC v. Elecs. Warehouse, Inc*., 689 F. Supp. 53, 73 (D. Conn. 1988)); *Kirkland*, 2006 WL 844839 at *1 (striking the unclean hands affirmative defense: "Not only do Defendant's allegations fail to rise to the level of egregiousness that might implicate constitutional deprivations, but Defendant has also failed to demonstrate how his defense in this matter has been prejudiced as a result of the SEC's alleged improprieties."); *In re Beacon Assocs. Litig*. 2011 WL 3586129, at *3-4 (S.D.N.Y. Aug. 11, 2011) ("The defense []… of unclean hands, if available at all against the government, require[s] that the misconduct be egregious and the resulting prejudice to the defendant rise to a constitutional level."); *SEC v. Lorin*, 1991 WL 576895 (S.D.N.Y. June 18, 1991) (striking unclean hands affirmative defense for failure to allege a violation of constitutional rights and egregious conduct).

Thus, an unclean hands affirmative defense cannot be raised except in the strictly limited circumstance where the defendant pleads: (1) the agency's misconduct is egregious; (2) the misconduct results in prejudice to the defense of the case; and (3) the prejudice to the defense rises to the level of a constitutional injury. *American Growth Funding II,* 2016 WL 8314623; *Rosenfeld*, 1997 WL 400131, at *2. Absent these allegations, an unclean hands defense fails as a matter of law. The Southern District of New York has explained the reasons why the bar is set high for this affirmative defense in government actions and is only available when needed to deter government abuses in cases involving constitutional injury:

> There are compelling reasons for setting a high bar so that the defense is only available when needed to deter government abuses. The government and its agencies are not like private litigants when they bring enforcement actions. These actions are intended to promote the interests of the public, and subjecting them to the same defenses as apply to private litigants would undermine the interest of the citizenry as a whole in obedience to the rule of law. Unlike a private litigant who may seek injunctive relief as an equitable remedy to enforce a private right, when a regulatory agency like the SEC requests injunctive relief, it typically does so because Congress has provided this statutory remedy for the public's benefit as a mechanism for effective law enforcement. As a matter of principle, except where

> there is a demonstrable need to deter governmental abuses, enforcement actions should not be subjected to an array of affirmative defenses—defenses that might not at all be relevant were the agency not seeking statutory equitable relief—that could undermine their efficacy as a law enforcement tool.
>
> And there are practical reasons as well. Affirmative defenses that are only conceivably relevant because the agency seeks a statutory equitable remedy can easily become instruments to challenge, and thereby to effectively derail, the enforcement action. The defense of unclean hands is a prime example. When this affirmative defense is asserted, rather than simply litigating whether the SEC is entitled to an injunction, the parties can become embroiled in a wide-ranging and intrusive dispute about how the SEC has conducted the enforcement action. When the focus of the litigation shifts from the defendant's alleged misconduct to the conduct of *both* the defendant and the SEC, delay and increased litigation expense are virtually certain to follow. The public's interest in effective law enforcement can be compromised, not because the public is at fault, but because a government agency seeking a statutory equitable remedy has been accused of wrongdoing.

Cuban, 798 F.Supp.2d at 794-95 (internal citations omitted).

Gold 7 fails to allege sufficient facts, even under a lowered pleading standard, to support an unclean hands affirmative defense against the Commission.

A. Gold 7 Fails To Allege Egregious Misconduct

Gold 7 fails to allege that the Commission engaged in any egregious misconduct and therefore an unclean hands affirmative defense fails as a matter of law. Instead, Gold 7's unclean hands affirmative defense is based on its allegations that the Commission (1) was allegedly investigating this case in 2018 and filed the case in Spring 2019, and (2) purportedly did not notify the "Department of Law Enforcement" [D.E. 77 at pp.30-31]. Even assuming, *arguendo*, that these facts are true,[2] they do not – and cannot – constitute misconduct, let alone egregious misconduct.

As for the purported failure of the Commission to bring this case sooner, Gold 7 fails to plead or even indicate that the Commission unreasonably delayed in bringing this action. *See Beacon Associates*, 2011 WL 3586129, at *3. Even if it had, "the SEC's failure to prosecute at an earlier stage does not estop the agency from proceeding once it finally accumulated sufficient evidence to do so." *Graham v. SEC,* 222 F.3d 994, 1008 & n.26 (2d Cir. 2000). *See also G.K. Scott & Co.,* 51 S.E.C. 961, 966 n.21 (1994) ("A regulatory authority's failure to take early action

[2] Because the investigation and any correspondence with law enforcement are non-public, Gold 7 has no basis whatsoever for making these allegations.

neither operates as an estoppel against later action nor cures a violation.") (internal quotation omitted), *review denied,* 56 F.3d 1531 (D.C.Cir. 1995) (table decision); *In re Beacon Associates Litigation*, 2011 WL 3586129, at *4 (S.D.N.Y. Aug. 11, 2011) (finding agency's alleged delay in taking action could not support affirmative defense and at most was negligence and not misconduct); *I.N.S. v. Miranda,* 459 U.S. 14, 18 (1982) (stating that negligent conduct is insufficient basis for estoppel claim against government); *SEC v. Culpepper,* 270 F.2d 241, 248 (2d Cir. 1959) (holding that neither failure to act after prior investigation of transaction in question nor "acquiescence" in transaction qualify as affirmative misconduct).

Nor can any delay in the Commission's investigation be construed to mean that the Commission has in any way given approval to any transaction. 15 U.S.C. § 78z ("No action or failure to act by the Commission . . . in the administration of this chapter shall be construed to mean that the particular authority has in any way passed upon the merits of, or given approval to, any security or any transaction or transactions therein . . . .").

As to the allegation that the Commission purportedly failed to notify "law enforcement," we set aside for the time being the fact that Gold 7 has no basis for alleging under Rule 11 whether or not Commission staff notified other agencies during its non-public investigation. *Even assuming* the Commission failed to notify other enforcement agencies, this is not misconduct, let alone egregious misconduct. The Commission is charged with enforcing the federal securities laws, and filed this action to enforce them.

2. Gold 7 Fails To Allege It Is Prejudiced In Defending This Case – Nor Could It

Even if Gold 7 had alleged conduct demonstrating egregious misconduct by the Commission – and it did not – Gold 7 does not allege that it faces any prejudice *in the defense of this action* due to the length of Commission investigation or the purported failure of the Commission to notify law enforcement. Accordingly, the affirmative defense fails as a matter of law. *See Rosenfeld*, 1999 WL 400131, at *2 (striking unclean hands affirmative defense where defendant failed to allege how defendant's ability to defend himself or his access to witnesses or evidence which would aid in his defense were compromised by the Commission's actions); *SEC v. Follick*, Case No. 00-cv-4385, 2002 WL 31833868, at *8 (S.D.N.Y. Dec. 18, 2002) (holding that unclean hands defense failed because defendant did not demonstrate prejudice where "[n]othing the SEC or any other Government actor [was] alleged to have done [would] prevent [defendant] from putting forth his defenses to this suit."); *In re Beacon Assocs. Litig.*, Nos.

09cv777 (LBS) (AJP), 10cv8000 (LBS) (AJP), 2011 WL 3586129, at *3-4 (S.D.N.Y. Aug. 11, 2011) (striking equitable defenses where, *inter alia,* defendants failed adequately to allege that they suffered "prejudice to their case of a constitutional magnitude").

In *Cuban*, for example, the Defendant alleged that the Commission staff engaged in three acts of investigative misconduct, and the Court found each failed to support an unclean hands affirmative defense because, among other reasons, they did not impact the Defendant's ability to defend the case. First, the Defendant alleged the Commission discouraged counsel for a key witness from making the witness available to speak with Cuban's counsel and failing to investigate. In striking the unclean hands affirmative defense, the Court found that the Defendant failed to allege that this resulted in any prejudice in the Defendant's "defense of this enforcement action much less prejudice that rises to a constitutional level." 798 F. Supp. 2d at 796. Second, the Defendant alleged that Commission staff threatened the same witness with perjury when he was unable during sworn testimony to clearly recall certain statements he had supposedly made to the Commission in a telephone interview. In striking the affirmative defense, the Court found that "Cuban does not allege that the SEC's conduct in any way impaired his ability to defend the enforcement action—for example, that he was thereafter unable to obtain truthful, favorable evidence from the witness—or that this conduct resulted in prejudice that rose to a constitutional level." *Id.* And, third, the Defendant asserted that Commission staff sent a letter to a website company that a separate investigation had been closed and then almost immediately took the sworn testimony of an individual associated with that company in an apparent effort to get him to change his earlier testimony. In finding this conduct did not give rise to an unclean hands affirmative defense, the Court found that "Cuban does not specifically allege that [the individual] changed his testimony, that any changed testimony impaired his ability to defend the enforcement action, or, critically, that this resulted in prejudice that rose to a constitutional level." Accordingly, the Court struck the affirmative defense.

Similarly, here Gold 7 fails to allege that the purported misconduct impaired its ability to defend this action. Instead, at most, Gold 7 alleges that had the Commission filed its case sooner, Gold 7 might not have purchased the diamonds at issue in this case. Gold 7 does not allege in any way that its ability to *defend* this case has been impaired. Accordingly, the Court must strike the affirmative defense.

3. Gold 7 Fails To Allege Any Constitutional Injury – Nor Could It

Even if Gold 7 had plead that the Commission engaged in egregious misconduct and that it was prejudiced in its defense of this case, it failed to allege any constitutional injury arising any misconduct. This is a third independent basis for striking the affirmative defense. *SEC v. KPMG LLP*, No. 03cv671 (DLC), 2003 WL 21976733, at *3 (S.D.N.Y. Aug. 20, 2003) (striking unclean hands defense where defendants did not contend that the Commission's conduct "constituted egregious misconduct or prejudice that rose to a 'constitutional level' "); *SEC v. American Growth Funding II, LLC*, 2016 WL 8314623 (S.D.N.Y. Dec. 30, 2016) (striking unclean hands affirmative defense where defendant failed to alleged egregious misconduct causing constitutional injury in defense of case); *SEC v. KPMG,* Case No. 03-cv-671, 2003 WL 21976733, at *3 (S.D.N.Y. Aug. 20, 2003) (holding that doctrine of unclean hands was inapplicable because SEC was acting to further its congressional mandate to investigate potential violations of the securities laws, and defendants did not, and could not, contend that SEC's failure to identify GAAP violation constituted egregious misconduct or prejudice that rose to constitutional level).

Here, Gold 7 alleges that had the Commission filed its case sooner or notified "law enforcement," Gold 7 would not have purchased the diamonds at issue. Gold 7 does not allege any constitutional injury whatsoever. Accordingly, the Court must strike this affirmative defense.

B. The Commission and Receiver Will Be Prejudiced
If The Affirmative Defense Is Not Stricken

It is well recognized in Commission enforcement actions that "[a]n increase in the time, expense and complexity of a trial may constitute sufficient prejudice to warrant granting a plaintiff's motion to strike." *SEC v. Thrasher,* 1995 WL 456402 at *4 (S.D.N.Y. Aug. 2, 1995) (striking several affirmative defenses). "Courts must not be oblivious to the caseload pressures and budgetary restrictions on government enforcement agencies, nor should they be unmindful that the discovery process can be unduly and unnecessarily delayed by counsel seeking to establish [meritless affirmative defenses]." *SEC v. Sarivola,* No. 95 CIV. 9270 (RPP), 1996 WL 304371 at *1 (S.D.N.Y. June 6, 1996) (striking affirmative defenses of laches and estoppel).

Gold 7 has sought discovery with respect to the unclean hands affirmative defense that would unduly intrude into the Commission's investigative process, or would disproportionately implicate privileged communications or attorney work product given the involvement of

Commission counsel in the investigation. Commission investigations are conducted by attorneys. Both counsel of record for the Commission in this case participated in the investigation.

Gold 7 has issued 80 requests for admissions to the Commission. Gold 7 seeks admissions from the Commission concerning, among other things the Commission's nonpublic investigation, Commission lawyers' knowledge during the investigation, and Commission attorneys' correspondence with law enforcement. Gold 7 has also issued a Request for Production which seeks, among other things, the following request that has no conceivable relevance other than to the unclean hands affirmative defense: "documents evidencing the first time the [Commission] was put on notice of the alleged Ponzi scheme more fully described in the Complaint." In addition, Gold 7 has propounded interrogatories to the Commission seeking, among other things, the dates on which the Commission notified "law enforcement" and the Gemological Institute of America ("GIA") that Aman stole diamonds and all communications with "law enforcement" and GIA concerning the diamonds, and the date the Commission learned of the alleged Ponzi scheme.

The discovery identified above has no relevance to the limited issues concerning the Commission's claim against Gold 7 as a relief defendant. To be clear, the only claim against Gold 7 is that it is a relief defendant, *i.e.*, that it received proceeds or assets of the alleged fraud and does not have a legitimate claim to the funds or assets. Gold 7 has admitted it received or obtained diamonds from Aman, and so the only issue is whether it has a legitimate claim to the diamonds. Gold 7 claims it acquired the diamonds through legitimate purchase agreements.

The requested discovery concerning the unclean hands affirmative defense would, at a minimum, prolong and complicate this litigation. This type of discovery, which would force the Commission to give attention to matters collateral to its claim against Gold 7 as a relief defendant, has been held sufficient to satisfy the Rule 12(f) requirement that the moving party show prejudice. *See, e.g., KPMG*, 2003 WL 21976733, at *3 (striking unclean hands affirmative defense: "The SEC has also shown that it will be prejudiced by allowing these affirmative defenses to remain in this litigation. The defendants have already given notice that they will seek to discover the internal workings of the SEC investigations of Xerox and KPMG to support these defenses."; *American Growth Funding*, 2016 WL 8314623 (striking unclean hands defense under Rule 12(f)(1) and finding Commission would be prejudiced by discovery concerning this affirmative defense and the Commission's investigation); *In re Beacon Assocs. Litig.*, 2011 WL 3586129, at *4; *KPMG*, 2003 WL 21976733, at *3.

"Prejudice is particularly clear where, as here, 'defendants have already given notice that they will seek to discover the internal workings of the [government] investigations of [Defendants] to support these defenses.'" *Beacon*, 2011 WL 3586129 (quoting *KPMG,* 2003 WL 21976733, at *3). Here, Gold 7 has propounded discovery seeking evidence about the Commission's non-public investigation. Gold 7 has pleaded no facts that could give rise to an unclean affirmative defense and should not be permitted to engage in a fishing expedition for wrongdoing without alleging any adequate factual basis for its unclean hands affirmative defense. *Id.* (striking affirmative defense and finding "Defendants will not be permitted to engage in a 'fishing expedition' for affirmative wrongdoing without alleging an adequate factual basis for these defenses."). *See also Rosenfeld,* 1997 WL 400131, at *2 (prohibiting defendant from using discovery to find evidence to make out estoppel defense).

Accordingly, the Court should strike Gold 7's unclean hands affirmative defense.

IV. CONCLUSION

WHEREFORE, the Court should strike Gold 7's fifth affirmative defense, of unclean hands, pursuant to Rule 12(f)(1) of the Federal Rules of Civil Procedure.

October 21, 2019

Respectfully submitted,

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CERTIFICATE OF CONFERRAL

Undersigned counsel conferred with counsel for Gold 7 by email and telephone. Counsel sent Gold 7 a draft of the instant motion on October 11, 2019, and Gold 7's counsel requested one week to research the issues before conferring. Accordingly, on October 18, 2019, undersigned counsel had a telephone conference with Gold 7's counsel after receiving cases from Gold 7 that

day. Gold 7's counsel stated it would simply insert "buzz words" that it suffered "constitutional injury" and the conduct was "egregious." When we attempted to discuss why simply inserting buzz words would not cure the defect, Gold 7's counsel began shouting and then hung up on Commission staff. Accordingly, we were not able to resolve this matter.

s/Amie Riggle Berlin
Amie Riggle Berlin

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SECURITIES AND EXCHANGE COMMISSION,

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ORDER GRANTING PLAINTIFF'S MOTION TO STRIKE RELIEF DEFENDANT GOLD 7'S FIFTH AFFIRMATIVE DEFENSE OF UNCLEAN HANDS PURSUANT TO RULE 12(f)(1)

THIS MATTER came before the Court upon the Motion to Strike Relief Defendant Gold 7's Fifth Affirmative Defense of Unclean Hands Pursuant to Rule 12(f)(1) by the Plaintiff Securities and Exchange Commission, and the Court, after reviewing the Motion and otherwise being duly advised,

IT IS HEREBY ORDERED that the Motion **IS GRANTED.** Relief Defendant Gold 7's Fifth Affirmative Defense of Unclean Hands Pursuant to Rule 12(f)(1) is stricken.

DONE AND ORDERED in Chambers in West Palm Beach,Florida, this ___day of October, 2019.

ROBIN L. ROSENBERG
UNITED STATES DISTRICT JUDGE

Copies to: Counsel of Record