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The Courts: Active Players in White-Collar Cases

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In June, the Supreme Court unanimously held that Enron's former CEO Jeffrey Skilling did not commit "honest services" fraud, ruling that the statute under which he was convicted must be limited to bribery and kickback schemes to avoid constitutional concerns over vagueness. *Skilling v. United States*, 130 S. Ct. 2896 (2010). The defense bar was heartened by these restrictions on a statute that federal prosecutors have used aggressively for years against public officials and more recently against corporate officers. The decision should curtail prosecution of a variety of conduct that the government would otherwise seek to criminalize through the statute. In contrast, the courts are expanding the reach of other criminal statutes to encompass conduct previously regarded as outside their scope.

United States v. Kaiser

In *United States v. Kaiser*, 609 F. 3d 556 (2d Cir. 2010), the Second Circuit abruptly lessened the government's burden of proof in securities fraud cases — apparently catching even the government by surprise — holding that the government need not prove that the defendant knew he was violating the securities laws. *Kaiser* arose out of allegations that the defendant fraudulently reported inflated company earnings in violation of securities laws, including § 32(a) of the Exchange Act, which criminalizes "willful" violations. Both the defendant and the government requested that the district court instruct the jury that willfulness requires that the defendant know his conduct is illegal.

Instead, the court charged the jury that the government had to prove the defendant knew the statements were false, that he made them with intent to deceive, and that the defendant was not simply mistaken or in good faith. In upholding the instruction, the Second Circuit drew a distinction between "wrongfulness" and "unlawfulness," and held that it was sufficient for the government to show that the defendant had "an awareness of the general wrongfulness of his conduct." The court acknowledged that, in *United States v. Cassese*, 428 F. 3d 92, 98 (2005), it had "seemed to endorse a higher standard for willfulness in insider trading cases" by requiring the government to prove that the defendant knew that he was doing a wrongful act under the securities laws. However, the court declined to impose that burden in *Kaiser*, reasoning that "insider trading does not necessarily involve deception, and it is easy to imagine an insider trader who receives a tip and is unaware that his conduct was illegal and therefore wrongful. The same cannot be said of one who deliberately misleads investors about a security."

The Second Circuit thus disregarded what previously had been a noncontroversial proposition, thereby criminalizing conduct that its own precedent did not reach. Prior Second Circuit cases involving non-insider trading securities fraud required the government to prove that a defendant be aware of the general unlawfulness of his conduct under § 32(a) of the Exchange Act, *e.g.*, *United States v. Becker*, 502 F.3d 122, 132 (2d Cir. 2007); *United States v. Cassese*, 428 F.3d 92, 98 (2d Cir. 2005).

Another Far-Reaching Decision

One week after *Kaiser*, the Sixth Circuit issued an equally far-reaching decision in the parallel world of the Investment Advisers Act of 1940, 15 U.S.C.S. § 80b-1 *et seq.*, holding that a jury could determine whether a hedge fund manager had a fiduciary relationship with an investor in his hedge fund. *United States v. Lay*, 2010 U.S. App. LEXIS 14380 (6th Cir. 2010). In so doing, the court resolved, at least in the Sixth Circuit, a question that had lingered since the D.C. Circuit's decision in *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006), which held that the SEC failed to offer adequate justification under the Act to treat investors as clients of hedge fund advisers.

In *Lay*, the defendant was an investment adviser to a state agency that was invested in a specific fund. The defendant subsequently founded his own hedge fund, into which the agency shifted additional funds. The defendant exceeded nonbinding investment guidelines and hid the extent of the risk, resulting in massive losses to the agency's investment.

The Sixth Circuit upheld a conviction of investment adviser fraud, rejecting the defendant's central argument that the duty of a hedge fund adviser is to the hedge fund and not the investors. The court held that it was proper to permit the jury to determine the existence of a fiduciary relationship between a hedge fund adviser and the investors. It found that the jury had sufficient evidence, including the defendant's investment adviser status in connection with the initial investment, the fact that the agency was the sole investor in defendant's hedge

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fund, and testimony that the second investment was part of the agency's single investment strategy.

Broad Ramifications

As fact-based as the *Lay* decision is, it has broad ramifications. The case affords hedge fund investors new claims based upon breach of fiduciary duty, and offers law enforcement the opportunity to prosecute such claims. However, in contrast to areas where the fiduciary relationship is well established, Lay permits claims where the adviser-client relationship may be unstated, ill-defined, and judged to exist only after the fact.

In addition to the judiciary's written decisions, there appears to be a snowball effect in which the judiciary is scrutinizing settlement agreements and imposing ever-increasing demands on the parties to justify their terms. In *United States v. Barclays Bank PLC*, 10-cr-00218, Judge Emmet Sullivan of the District Court for the District of Columbia criticized a deferred-prosecution agreement between the Department of Justice (DOJ) and Barclays Bank PLC. Barclays was charged with secretly moving hundreds of millions of dollars through the U.S. financial system on behalf of banks from countries that had been sanctioned and embargoed by the federal Office of Foreign Assets Control (OFAC). According to filings in the case, the conduct may have begun as early as the mid-1980s, and Barclays failed to heed concerns raised by employees beginning in 2001.

Barclays self-reported the violations and, in resolution of the matter, waived indictment, agreed to remedial measures, and agreed to forfeit $298 million, with a concurrent $176 million settlement with OFAC that was deemed satisfied by the forfeiture. DOJ agreed to recommend dismissal of the Information in two years if Barclays fulfilled the terms of the agreement. Judge Sullivan criticized the settlement as a "sweetheart deal," questioned the forfeiture as too small, noted that the shareholders would bear the burden of the financial sanctions, and asked whether any Barclays officers were being held responsible. Although Judge Sullivan approved the deferred-prosecution agreement, noting that it was not his job to micromanage DOJ, it appears that he intends to keep the parties under strict scrutiny. An order filed on Aug. 18, 2010, requires the parties to report to the court their progress under the agreement and sets the matter down for a November status hearing.

Court Involvement

The court's involvement in a criminal settlement builds upon the involvement of prior courts in SEC civil cases. In the widely reported case of *SEC v. Bank of America Corp.* 09-cv-6829 (S.D.N.Y.), Judge Jed S. Rakoff castigated the SEC for its proposed settlement with Bank of America in connection with its acquisition of Merrill Lynch. Calling the settlement unfair, unreasonable, and inadequate, Judge Rakoff rejected it last year, pointing out that it penalized the shareholders and failed to seek penalties from culpable individuals. Judge Rakoff approved the settlement only reluctantly this year, after he forced the parties to make significant changes.

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More recently, another proposed SEC settlement came under fire from D.C. District Court Judge Ellen S. Huvelle. In *SEC v. Citigroup Inc.*, 10-cv-01277, the SEC alleged that Citigroup misled investors about its exposure to subprime mortgage-related assets. In separate administrative proceedings arising from the events, the SEC filed actions against a current and a former Citigroup officer. Simultaneously, the SEC announced that it had settled the case against Citigroup, which agreed to pay a $75-million penalty. The settlement proposed the establishment of a fund to distribute the penalty to shareholders harmed by the disclosure violations. In addition, the SEC announced that it had settled the administrative proceedings, with the individuals agreeing to pay $80,000 and $100,000, respectively. While the proposal seemed intended to address concerns raised in the *Bank of America* case, neither the court nor an increasingly vocal public were satisfied.

Instead, Judge Huvelle ordered a hearing and directed the parties to defend the proposal as consistent with the public interest. (Minute Order, entered Aug. 9, 2010). As precedent for her order, Judge Huvelle cited *Bank of America*. In addition, in an amicus brief, a Citigroup shareholder faulted the SEC for failing to identify Citigroup senior management described in the complaint, argued that the administrative proceedings targeted low-level "fall guys," and advocated a lengthy list of remedial measures. (Lerner Memorandum, filed Aug. 12, 2010).

Responding to the court's questions, the SEC identified the unnamed individuals in the complaint, justified the administrative proceedings, explained the economic analysis underlying the settlement amount, and addressed the forms of non-monetary relief proposed by the shareholder. (Order, entered Aug. 17, 2010; SEC Memorandum, filed Sept. 8, 2010). Judge Huvelle indicated at a recent hearing that she would approve the settlement on certain conditions: She directed the SEC to certify that Citigroup's procedural remedies were adequate and would remain in place for a given period of time, and also required the parties to redraft the settlement to make clear that the $75 million would be used to compensate shareholders who had suffered losses as a result of the misstatements.

Conclusion

For those in the defense bar watching these trends, it is clear that the judiciary has become increasingly active in both litigation and settlement of white-collar cases. As concerned as the defense bar is with overzealous prosecutors, it is equally important to be mindful of the concerns that the courts have vigorously expressed on behalf of a public that may be affected by perceived wrongdoing. The practical effect of this increased judicial scrutiny remains to be seen. At least in the short term, the judiciary has become an increasingly active — but unpredictable — player in the white-collar arena.