

Of Telephones and Corruption in Latin America: How a Bribery Case Involving a Florida Company Contributed to The Fall of the Government in Honduras

In the pre-dawn hours of a Saturday in late June 2009, military troops bearing automatic weapons and arrest warrants roused Honduran President Manuel Zelaya from his bed. Hours later, the troops escorted Zelaya, still clad in his pajamas, from the country. The head of congress and man next in line for the presidency, Robert Micheletti, settled into the tile-roofed presidential palace in downtown Tegucigalpa. As this dispute simmered over the summer, some called the events a coup, resulting from Zelaya's push for a referendum on his ability to seek re-election. Others branded the events an illegal seizure of power from a democratically elected president. But few realized the role in these dramatic events of a powerful U.S. anti-corruption law that has drastically changed the nature of international business.

This law, the Foreign Corrupt Practices Act (FCPA), prohibits businesses and persons with U.S. ties from making payments to foreign officials to obtain or retain business. The law has played a growing role in U.S. efforts to bring transparency to developing nations by penalizing those who try to open doors for business with

Corruption presents a significant challenge to developing nations, impeding economic growth, distorting competition, diverting important public resources and corroding the institutions of a civil society.

illicit payments. The law's reach is broad, touching many business practices – like payments to pass goods through customs or reserve precious airplane cargo space – that some had come to see as standard procedure in foreign markets. U.S. law enforcement increasingly stresses the importance of an ethical business culture, and enforces these lessons with multi-million dollar fines and jail time for those who stray. The events in Honduras demonstrate this effort.

The 'Prize' of Doing Business in Honduras

In a federal courtroom in Miami, two months prior to Zelaya's ouster, the new owners of a Florida company, Latin Node Inc. (Latinode), stood ready to face a judge and answer for making corrupt payments that reached into the highest levels of the Honduran government. A few years earlier, Latinode had sought to open a relationship with Hondutel, the state-owned telephone company in Honduras, to provide wholesale telephone services. Despite "financial weaknesses" in its bid for an access agreement, Latinode hoped that a "prize" it offered to a senior Hondutel official might nonetheless make the difference. The prize took the form of \$300,000 passed by Latinode through sham consulting firms to Honduran officials considering the proposal.

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After securing the deal, Latinode sought concessions from Hondutel. Honduran officials said it would be necessary to “give something” to them to obtain the preferred rate and capacity sought by Latinode. The officials made the giving easy, providing their own bank account information, where ultimately over \$1 million was passed. The officials concealed the rate change from the public, and instead told Latinode to inflate its monthly statements of minutes purchased. Latinode paid two Hondutel employees to make official records correspond to the inflated bills. Latinode even hired a former Hondutel official to lead its Latin American operations.

After gaining these concessions, Latinode sold its operations in 2007 to eLandia International Inc., a publicly traded company. The new owners soon discovered they had inherited a tremendous mess, and took important steps under U.S. law to limit the damage. After conducting an internal review, eLandia reported the misconduct in Honduras to U.S. prosecutors. This type of self-disclosure is an important function for companies that uncover misconduct, and prosecutors ultimately lauded these “commendable” and “authentic” efforts as “exemplary” cooperation. The disclosures, however, were costly to eLandia, which later reported that it had overpaid roughly \$20 million for Latinode, given the resulting criminal exposure and loss of business. Indeed, eLandia cancelled the Honduran contracts and placed Latinode into a dormant state in order to avoid further problems.

Prosecutors soon brought charges, alleging that Latinode had bribed its way into the Honduras business through payments to several Honduran officials, identified by prosecutors only by initials and their functions in Hondutel. The charges stated that Latinode paid more than \$1 million to “Official A, Official B, Official C, and other Honduran officials” to obtain the telephone contract and reduce the per-minute rate.

Honduras Does Not Stand Alone

The Latinode case is not the first corruption touching Latin American telephone networks. In September 2008, a federal judge in Miami sentenced a former Alcatel CIT executive to 30 months of imprisonment for engaging in an elaborate bribery scheme to obtain mobile telephone contracts from the Costa Rican state-owned telecommunications authority. The official, Christian Sapsizian, promised to pay officials up to 2 percent of the contract’s value. Before being fired in 2004, Sapsizian

caused Alcatel to wire \$14 million in “commission” payments to a consultant, who then transferred \$2.5 million to Costa Rican officials.

Charges of corruption in Costa Rica debilitated the local civic culture. In late 2004, an international watchdog group found Costa Ricans to be the second most pessimistic nation when it came to corruption. A year later, a local newspaper poll found 32 percent of the population planned to abstain from elections, a rate the newspaper said demonstrated “a weakening of democracy, particularly because of misuse of powers and the inefficiency of politicians.”

Costa Rican authorities have sought to investigate the role of political powers in the bribery, and the chief prosecutor of Costa Rica, Francisco Dall’Anese, is seeking to interrogate Sapsizian. U.S. officials denied Dall’Anese entry into the country on his first visit, resulting in a diplomatic protest and claims that the United States was intentionally placing many obstacles in the way of Costa Rica’s review. But a subsequent trip gave Dall’Anese access to information, ultimately leading to charges against former Costa Rican President Miguel Angel Rodríguez for accepting bribes in connection with the telephone contracts. In a late August 2009 interview, Dall’Anese said the case against former President Rodríguez has passed the preliminary process stage and has been ordered to trial by a judge.

The Hondutel Bribes Touch Zelaya’s Inner Circle

While the American papers largely overlooked the Alcatel and Latinode cases, the Honduran press quickly noticed. Some Honduran newspapers had been reporting on irregularities at Hondutel since 2007, focusing primarily on the role of Marcelo Chimirri, Hondutel’s manager and President Zelaya’s nephew. The story took a macabre turn in February 2008, when a truck rigged with a false compartment for smuggling was found burned underneath a bridge in Comayagua, Honduras, with four men inside. One of the men is reported to have been providing information – including a 49-minute recorded conversation with a person believed to be Official C – about efforts by Hondutel officials to extort money from his business.

The new allegations from the Latinode case magnified the interest. Speculation ran concerning the identities of the unnamed officials, and the press soon identified

Latinode Lessons for Responsible Companies

The Latinode case exemplifies many important points for companies addressing issues under the Foreign Corrupt Practices Act, including the importance of conducting pre-acquisition due diligence of target companies to ensure that FCPA enforcement problems are not coming along in the deal and that the target's foreign business will remain valuable and profitable.

In June 2007, eLandia bought Latinode for \$26.8 million. Within months, the company reported Latinode's FCPA violations to the Justice Department, and began to realize that this purchase was overvalued by \$20.6 million. While pre-acquisition due diligence will not catch all FCPA problems, it is a necessary part of every acquisition to make sure that the buyer is getting what is expected. The due diligence also protects a company from purchasing an asset that will come along with its own FCPA investigation, as the Justice Department takes the view that an acquiring company, bank or investor may face liability for past acts of an acquired company that would have violated the FCPA had the acquired company been subject to the FCPA at the time. The best defenses against these liability issues is to conduct probing and effective pre-acquisition FCPA due diligence, and to maintain a strong compliance program to avoid ongoing FCPA issues.

Quickly addressing FCPA issues when they arise is another important lesson from the Latinode case. When eLandia uncovered the misconduct after the Latinode purchase, it immediately began an internal review of the facts and provided timely and thorough reports on these facts to the prosecutors. Senior Latinode officials responsible for the problem were dismissed, and eLandia took steps to strengthen its own FCPA compliance efforts. These efforts resulted in substantial benefits, as prosecutors declined to charge eLandia itself, did not require eLandia to enter a deferred prosecution agreement or retain a corporate monitor, and recommended a fine that was less than half of what the minimum sentencing guidelines would ordinarily have required.

Finally, the case demonstrates the potential negative impact from condoning improper conduct in foreign markets. The Hondutel bribes facilitated a culture of secret deals and vast wealth to a few well-connected persons. The debris left behind includes contracts hidden from public view, bogus accountings of the scarce public resource of telephone service, physical harm to an extortion victim who tried to clear the air, and possibly even the downfall of a president. Being associated with these elements is a disaster for any responsible company seeking to engage in ethical and proper business.

candidates for each pseudonym. Most spectacular was the identification of "Official B" as Chimirri. Chimirri has maintained that he did not sign contracts or lower tariffs for Latinode, asserting that his accusers are seeing "pink elephants" and using "who knows what kind of psychotropic substances." Chimirri also denied claims that his fortune, including luxury cars, thoroughbred horses and a mansion, had an "obscure origin."

President Zelaya had denied that there was evidence of any tariff reduction or of any wrongdoing in his government, but was forced to change his opinion following Latinode's guilty plea. As auditors from Chile came in to help unravel Hondutel's finances, the new Hondutel manager Jorge Rosa guaranteed the investigation would result in the punishment of those responsible. In the days before Zelaya's ouster, Rosa promised that Hondutel was giving investigators all the information they sought. "Here, nothing will be forgotten," Rosa said. The investigation "will be what all Hondurans want – a transparent answer and solution."

Since Zelaya's removal, Honduran officials have arrested and detained Chimirri and others from the Latinode affair. Honduran prosecutors continue to investigate, including against President Zelaya. More disclosures surely will follow.

The High Cost of Corruption

Did the Hondutel events lead to President Zelaya's ouster? They certainly seem to have been a contributing factor, as the Honduran press has noted since his removal. In any event, corruption presents a significant challenge to developing nations, impeding economic growth, distorting competition, diverting important public resources and corroding the institutions of a civil society. The impact on poorer communities is particularly acute. As the World Bank recognized some years ago, "corruption and poor governance worsen poverty directly – by diverting resources away from the needy – and indirectly – by harming the climate for private investment, key to growth and poverty reduction." In short, the misuse of power holds nations back from reaching their social and economic potential.

Enactment and enforcement of anti-corruption efforts worldwide, like the FCPA and the Organization for Economic Co-operation and Development Convention of Combating Bribery of Foreign Public Officials, not only is prompting businesses to adopt measures to protect their

reputations and shareholders, but also is reshaping the concept of good business practices for an ethical company. The Hondutel case provides a great reminder of these important concepts.

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Ninth Circuit CDT Ruling Has Major Implications for Seizures of Computer Information

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In *United States v. Comprehensive Drug Testing* (CDT) and two companion cases, the Ninth Circuit Court of Appeals *en banc* issued a far-reaching decision about court-ordered searches and seizures of computers and electronically stored information (ESI) that may be reviewed by the U.S. Supreme Court. The *CDT* case, which arose out of a federal investigation into steroid use by professional baseball players, is a must-read for those affected by court-ordered searches for ESI.

The Ninth Circuit, in an effort to “strike a proper balance between the government’s legitimate interest in law enforcement and the people’s right to privacy and property,” established a five-part protocol for searches and seizures of computers and ESI pursuant to warrants that authorize “over-seizure” and subsequent off-site segregation of data for which there is probable cause. Most importantly, federal judges in the Ninth Circuit issuing search warrants must now “insist the government waive reliance upon the plain view doctrine in digital evidence cases.”

In addition, the government must follow strict rules regarding segregation and redaction of ESI, disclosing the risk of destruction of ESI, limiting its search protocol to uncover only information for which it has probable cause, and destroying or returning non-responsive ESI. As discussed by the dissenting opinions, these requirements arguably represent a departure from precedent.

Facts of the Case

At issue in *CDT* was the government’s effort to obtain its desired information in any way possible, using multiple subpoenas and two search warrants from three different districts. CDT was a company that administered a steroid

It seems likely that we will see more case law developments as the courts try to balance privacy interests and the application of the plain view doctrine to ESI searches and seizures.

testing program for the Major League Baseball Players Association. After learning that ten players tested positive for steroid use, the government obtained a grand jury subpoena in the Northern District of California for all drug testing records and specimens from CDT. CDT and the players moved to quash the subpoena.

Despite CDT’s assurances that it would preserve all data until the motion to quash was decided, the government responded to the motion to quash by seeking a search warrant in the Central District of California for records of the ten players identified by the government as having tested positive for steroid use. In its application for the warrant, the government made a generic argument for over-seizure, describing the ease with which electronic information can be hidden and the difficulty in properly examining and segregating electronic information at the site of the search. The government did not disclose CDT’s promise to maintain the data requested by the Northern District subpoena. The Central District Court issued the warrant and authorized over-seizure, but provided safeguards requiring independent review and segregation of non-responsive data.

In addition to the California proceedings, the government obtained a search warrant in the District of Nevada for the tested specimens and additional information regarding the steroid tests. The government then issued new subpoenas in the Northern District of California for the same information it had obtained in Nevada.

CDT and the players filed a motion under Fed. R. Crim. P. 41(g) for return of the property seized in the Central District of California. In executing the warrant, the government seized and reviewed the drug testing records of hundreds of players and “a great many other people.” The District Court granted the Rule 41(g) motion, finding that, despite the warrant’s authorization of over-seizure, the government “failed to comply with the conditions of the warrant designed to segregate information as to which the government had probable cause from that which was swept up only because the government didn’t have the time or facilities to segregate it at the time and place of the seizure.” The court “concluded that the government’s actions displayed a callous disregard for the rights of third parties, viz., those players as to whom the government did not already have probable cause and who could suffer dire personal and professional consequences from a disclosure.”

Additional motions were brought in Nevada with the same result, with the exception of materials seized relating to the ten identified ballplayers. In Nevada, the court ordered that all traces from the improper seizures in the government’s possession be destroyed. The subpoenas from the Northern District of California also were quashed. In short, the district courts rebuffed government arguments that they had complied with the court-ordered search protocols, and that their seizures regarding all the baseball players were authorized under the plain view doctrine, or that they were otherwise allowed to retain evidence from the searches.

Ninth Circuit’s *En Banc* Ruling

In *CDT*, the Ninth Circuit upheld all three district court orders. At the outset, the Circuit Court found that the government’s claims of error were essentially precluded due to an untimely appeal, but, to “avoid any quibble” about the proper scope of preclusion, substantively reviewed the district court orders anyway.

In addressing the government’s plain view argument, the Ninth Circuit found that the purpose of the ESI over-seizure search protocols was “to maintain the privacy of materials that are intermingled with seizable materials and to avoid turning a limited search for particular information

Attorney Spotlight: Jeremy D. Frey



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Mr. Frey focuses his practice on internal investigations for public and privately held businesses, SEC investigations and enforcement proceedings, corporate compliance, public authorities, federal tax matters, real estate and commercial litigation, class action cases, qui tam proceedings, patent and health care litigation, environmental compliance matters, whistle-blower employment cases, First Amendment litigation, forfeiture proceedings and extensive representations of businesses and individuals in federal and state criminal investigations and cases.

Before joining the firm, Mr. Frey was the Assistant U.S. Attorney-in-Charge of the U.S. Attorney’s Office in Camden, New Jersey. In more than 15 years as a prosecutor, Mr. Frey tried dozens of major cases and supervised hundreds of others.

Mr. Frey has taught at Rutgers University School of Law and has presented continuing legal education courses on criminal practice, federal sentencing guidelines, health care fraud, the attorney-client privilege, insider trading, e-discovery and broker-dealer registration. He sits on the Advisory Board of BNA’s *White Collar Crime Report*.

Mr. Frey received a B.A. degree from Oberlin College in 1976 and is a member of Phi Beta Kappa. He received his J.D. from New York University School of Law in 1979, where he was an editor of the *Annual Survey of American Law*. Mr. Frey is a member of the Pennsylvania and New Jersey bars.

into a general search ...” The Ninth Circuit did not quibble with the government’s assertion that ESI can be easily hidden and difficult to recover, but it did dismiss the idea that permitting over-seizure to address the concerns meant that all ESI would fall under the plain view doctrine: “If the government can’t be sure whether data may be concealed, compressed, erased or booby-trapped without carefully examining the contents of every file – and we have no cavil with this general proposition – then everything the government chooses to seize will, under this theory, automatically come into plain view. Since the government agents ultimately decide how much to actually take, this will create a powerful incentive for them to seize more rather than less ...” Such an approach would encourage the government to “take everything back to the lab, have a good look around, and see what [it] might stumble upon.”

To prevent the government from converting every court-ordered search for ESI authorizing over-seizure into a general warrant, the Ninth Circuit announced that “the government should, in future warrant applications, forswear reliance on the plain view doctrine ... that would allow it to retain data to which it has gained access only because it was required to segregate seizable from non-seizable data.” The court added that if the government did not wish to provide such a waiver, an independent third party must do the segregation under the supervision of the court, or the warrant request should be denied.

The Ninth Circuit also gave additional directions about court-ordered searches of computers and ESI. As an initial matter, the government, when seeking a warrant, must disclose the “actual degree” of risk of “concealment and destruction of evidence” as opposed to a generic recitation of the difficulties that might be posed by ESI collection. The government must also disclose any promise of the party possessing the data to preserve it. “Such pledges of data retention are obviously highly relevant in determining whether a warrant is needed at all and, if so, what its scope should be.” Once the government has obtained a warrant, it must ensure that (a) segregation of seizable materials must be done by a “screen team” or third party, (b) the ESI searches by the government are designed to uncover only information for which it has probable cause (which is the only ESI that may be provided to the case agent), and (c) non-responsive data is either destroyed (if the data is illegal to possess) or returned.

Separately, the court upheld a broad reading of Rule 41(g) authorizing a court in appropriate circumstances to require the government to destroy all information in its possession

seized under a warrant not executed in accordance with its restrictions.

Analysis of the Ruling

The Ninth Circuit’s updated measures in *CDT* help promote Fourth Amendment protections against unreasonable searches and seizures in the context of computer and ESI over-seizures. Authorized over-seizures and subsequent off-site searching of the data by law enforcement are often necessary as a practical matter. Without other constraints, however, the plain view doctrine applied in ESI over-seizure cases can encourage unjustified intrusions by law enforcement into protected privacy in the absence of probable cause.

The complaints of the dissenters in *CDT* are not easy to dismiss. They argued, among other things, that the majority opinion departed from precedent by providing heightened Fourth Amendment protection to ESI. Moreover, they argued that the majority’s expansive ruling was unnecessary, and the case should have been decided more narrowly based on the government’s non-compliance with the warrant restrictions or inapplicability of the plain view exception.

Nevertheless, there is heightened risk of unjustified invasion of privacy interests with ESI. The volume of information that can be stored electronically on a single disk, computer, or server makes ESI different than paper documents. As this case demonstrates, giving the government unfettered access to massive quantities of information when it has reason to search for and seize only a small portion erodes the Fourth Amendment’s probable cause requirement. While requiring the government to waive reliance on the plain view doctrine in authorized over-seizure cases is one remedy, the Ninth Circuit’s categorical rule may sweep too broadly if it denies the government evidence otherwise properly discovered under the plain view doctrine during the course of an authorized search. Though the government’s unsavory conduct in *CDT* justified suppression under the circumstances of that case, the majority opinion may not persuade other federal courts outside the Ninth Circuit to adopt its categorical protocol to *all* warrants that permit over-seizure of ESI.

Even so, *CDT* represents an important development in protecting privacy interests by acknowledging the heightened risks of unjustified privacy invasion associated with seizures of ESI. Long-established rules applying to seizure of paper documents and other tangibles may not

be sufficient to address this risk. Though *CDT*'s approach to plain view waiver may be too categorical, it seems likely that we will see more case law developments as the courts try to balance privacy interests and the application of the plain view doctrine to ESI searches and seizures.

For those courts that will be parsing *CDT*, the Ninth Circuit left unsettled whether its protocol is constitutionally based—including most critically the requirement of plain view waiver where there are authorized over-seizures of ESI. Dissenters in *CDT* claimed that the protocol was *dicta* and not part of the *en banc* Ninth Circuit's holding. In any event, it seems likely that the protocol will be interpreted as an exercise of the court's supervisory power, but still as binding precedent on the lower federal courts in the Ninth Circuit. For cases in federal courts outside the Ninth Circuit, *CDT* brings new sizzle to Fourth Amendment suppression claims in ESI over-seizure cases. *CDT* is not binding on federal courts outside the Ninth Circuit, or on any state courts.

Because *CDT* arguably gives heightened Fourth Amendment protection to computers and ESI, while restricting the venerable plain view doctrine in new ways, the Ninth Circuit's ruling is a candidate for U.S. Supreme Court review if the government decides to appeal. To the extent that the government interprets *CDT*'s plain-view waiver requirement as constitutionally based, an appeal to the Supreme Court seems more likely, notwithstanding that the government's distasteful conduct leading up to *CDT* might otherwise diminish the government's inclination to seek review.

The question of whether the government will appeal now has to await a new development. Early in November, the Ninth Circuit entered an order asking the parties for briefs on whether the case should be reheard by the full Ninth Circuit, which has an authorized complement of 28 active Circuit judges.

In the meantime, persons aggrieved by seizures of computers and ESI based on search warrants, and criminal defendants seeking to suppress incriminatory evidence resulting from such warrants, should carefully review *CDT* for its application to their circumstances.

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News and Noteworthy

- **Frank C. Razzano** is scheduled to moderate a panel on honest services fraud at the ABA Criminal Justice Section's 24th Annual National Institute on White Collar Crime in Miami, Florida in February 2010.
- **Frank C. Razzano** and **Kristen Jones** published, "The Supreme Court Delves Into Uncertainties Surrounding the Honest-Services Fraud Statute" in the October 23 issue of the BNA's *White Collar Crime Report*.
- **Jeremy D. Frey** and **Ivan B. Knauer** spoke on "Broker Dealer Registration and Commercial Transactions" at a recent CLE program held in Pepper's Philadelphia office.
- **Michael A. Schwartz** and **Jeremy D. Frey** participated in a roundtable discussion titled "Hedge Funds: What Is Happening Now" at a recent program held in Pepper's New York office.
- **Michael A. Schwartz** recently spoke at the Philadelphia Law Department and Philadelphia District Attorney's Office annual meetings on "Honest Services Fraud and Ethics/Campaign Finance Reform." Mr. Schwartz also is teaching a class, "Corruption Law and Policy," at Temple University's Beasley School of Law during Spring 2010.
- **Jeremy D. Frey** contributed to "Unsworn Witness Concerns Justified Disqualifying Accused's Long-Time Counsel," in the November 6 issue of the BNA's *White Collar Crime Report*. Mr. Frey also contributed to the article "Attorneys, Academics Sort Through Landmark Case on Computer Searches," which was published in the September 16 issue of BNA's *Electronic Commerce and Law Report*.
- **Thomas M. Gallagher** recently spoke at the Indiana University School of Law Annual Continuing Legal Education Program "Corporate Integrity: Meeting Challenges and Doing the Right Thing." The topic of Mr. Gallagher's speech was "Living With a CIA: Day One and Beyond."

Federal Honest Services Fraud Law at the Crossroads

On December 8, 2009, the U.S. Supreme Court will hear oral argument in *Black v. United States* and *Weyhrauch v. United States*, which promise to be among the most significant white collar crime cases of the decade. In these cases, the Court is expected to decide whether the federal honest services fraud (HSF) statute (18 U.S.C. Section 1346) is constitutional and, if so, what limiting principles apply.

Earlier this year in *Business Law Today*, we argued that the HSF law was so vague that it invites challenge on constitutional grounds. Razzano and Jones, "Prosecution of Private Corporate Conduct: The Uncertainties Surrounding Honest Services Fraud," 18 *Business Law Today* No. 3, p.37 (January/February 2009). Shortly thereafter, Justice Scalia in a dissent from the denial of *certiorari* in *Sorich v. United States*, 129 S. Ct. 1308, 1309 (2009), took a similar view in commenting on the HSF statute's remarkably broad reading. More recently, we argued in BNA's *White Collar Crime Report* ("The Supreme Court Delves into Uncertainties Surrounding the Honest-Services Fraud Statute," Razzano and Jones, 10-22-09) that due to the uncertainties surrounding the HSF statute, the Supreme Court should declare it unconstitutional. With the upcoming oral arguments in *Black* and *Weyhrauch*, we expect to gain additional insight into the Court's thinking on whether the HSF statute offends constitutional due process, or whether the Court will choose to fashion some kind of limiting principle to cabin its reach.

Background

The federal mail fraud statute, which became law following the Civil War, currently provides "whoever, having devised or intending to devise, any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretense, representations or promises" shall be fined, imprisoned not more than 20 years, or both. The statute failed to define what a "scheme or artifice to defraud" is. Over the course of the next hundred years, courts came to define the terms as "all false representations past, present, or future." The typical jury charge told jurors that it encompassed "any conduct which fails to match the reflection of moral uprightness, fundamental honesty, fair play and right dealing in the general and business life of members of the community." As one court noted, this amorphous definition constitutes nothing more than a

Since Section 1346's honesty requirement fails to provide any defined standards of conduct that citizens are required to meet, the statute should be declared unconstitutionally vague and sent back to Congress.

sixth-grade civics lesson. But by the 1970s, courts and prosecutors began to use this amorphous definition to include schemes to deprive others of the intangible right of a defendant's honest services. This intangible right of honest services was applied in two distinct areas – public- and private-sector cases. In public-sector cases, the theory of fraud rests on the principle that public officials and public employees owe duties of honest services to the public. Private sector HSF cases rest on the theory that private persons, when acting in various capacities, also owe others, such as their employers, duties of honest services.

In the public HSF arena, until the 1950s the federal government played little role in policing corruption among state and local officials. There was a federal bribery statute, which was one of the first bills enacted by Congress in 1789, 18 U.S.C. Section 201. It applies, however, only to federal officials, not to state or local officials. There was no federal law aimed at state or local corruption. By the 1960s, prosecutors began bringing cases under the federal Travel Act, 18 U.S.C. Section 1957 (outlawing interstate transportation of money in aid of bribery and the extortion statute) and the Hobbs Act, 18 U.S.C. Section 1951 (outlawing payments under color of official right) to attack state and local political corruption.

In the 1970s, however, prosecutors began to employ the federal mail and wire fraud statutes on the theory that when a state or local public official takes a bribe, the official deprives the public of its right to the official's honest services. Since mail and wire fraud are predicate crimes under the federal racketeering statute (RICO, 18

U.S.C. Section 1961 et seq.), prosecutors also started bringing charges under the new federal RICO statute. The prosecution of Maryland Gov. Marvin Mandel catapulted honest services fraud and RICO to the forefront of the federal government's effort to fight state and local corruption. At the same time, prosecutors also began charging private HSF cases as well on the theory that, for example, employees who took bribes deprived their employers of honest services.

In 1987, the Supreme Court struck down the honest services fraud theory in *McNally v. United States*, holding that the mail fraud statute protects property rights, not an intangible right to honest services. In the wake of *McNally*, Congress passed 18 U.S.C. Section 1346, which defined a scheme or artifice to defraud as including "a scheme or artifice to defraud another of the intangible right of honest services." There is virtually no legislative history of Section 1346. When Section 1346 was passed, the term "intangible right of honest services" had no common law meaning; it was not defined in *Black's Law Dictionary*, and there were only a handful of federal circuit courts that had addressed cases involving honest services fraud before the theory was disavowed by the Supreme Court in *McNally*.

In the years following Congress' enactment of Section 1346, the courts began a struggle to define what the intangible right to honest services means, without the benefit of any developed jurisprudence. As a result, federal courts throughout the country came up with varying and, at times, conflicting limiting principles. While all the circuits could agree that Section 1346 should not be interpreted to transform every breach of a workplace rule or ethics violation into a federal crime, the courts could not agree on what limiting principle would allow them to achieve an appropriate result consistent with the constraints of federalism. Among the issues courts have wrestled with are whether an HSF violation also requires violation of a state criminal law, a state civil statute, or whether breach of a state or "federal" common law duty will suffice. In cases of omissions to act, such as failures to disclose conflicts of interest, the issues have become even more obscure. In the past five years, with federal prosecutors aggressively pursuing their view of public corruption, the varying formulations in the courts of what conduct can constitute an HSF crime has produced a national spectacle.

Supreme Court to Review HSF Statute

The Supreme Court's *certiorari* grants in *Weyhrauch* and *Black*, as well as more recently in the private HSF case of *Skilling v. United States*, bring the promise that some order will be imposed. *Weyhrauch*, a public HSF case, involved an Alaska state legislator whose public position was a part-time job. Weyhrauch sought a job with an oil field services company after he determined he would not run for re-election. As it turned out, legislation was pending before the Alaska legislature that would benefit the company that was Weyhrauch's potential employer. Weyhrauch was indicted and convicted by a jury for failing to disclose the conflict of interest created by his voting on the legislation. The prosecution conceded on appeal that Weyhrauch violated no state statute requiring disclosure of the conflict of interest. Nevertheless, the Ninth Circuit upheld Weyhrauch's conviction, and found that Weyhrauch's conduct in not disclosing the conflict violated "federal common-law." In his petition for *certiorari* before the Supreme Court, Weyhrauch argues, among other things, that there is no federal criminal common law, and that declaring it in his case violates due process. Weyhrauch also argues that Section 1346 must be interpreted in accordance with the rule of lenity, which requires that any ambiguity be resolved in his favor.

Black is a private-sector case. In *Black*, senior executives of Hollinger International received \$5.5 million in exchange for a non-compete agreement. Neither the company's Audit Committee nor its board was informed of or approved the transaction as required by the conflict issue the transaction raised. The defendants argued that the payment was really a management fee, but was characterized as a non-compete agreement in order to address issues under Canadian tax laws. The Seventh Circuit found that Black owed a fiduciary duty of loyalty and candor to Hollinger, and that he and others misused their positions for personal gain in connection with the transaction. As a result, Hollinger was deprived of its right to their honest services. The question presented in the petition for *certiorari* in *Black* is whether HSF requires economic or other property harm to a private party to whom the duty of honest services was owed. The Seventh Circuit requires only a breach of fiduciary duty for personal gain at the expense of the party to whom the duty is owed and not foreseeable harm.

Like *Black*, *Skilling* also is a private HSF case, although *certiorari* in *Skilling* was granted after *Black*. *Skilling* is the former Enron CEO. His *certiorari* petition argues that private gain is required to sustain an HSF conviction, and that without such a requirement, the statute is unconstitutionally vague. Just as in *Weybrauch* and *Black*, the fundamental question presented to the Court in *Skilling* is whether to fashion a limiting principle as to the reach of Section 1346 or whether that is a legislative function.

In our view, it is the role of Congress, not the Supreme Court, to establish such limiting principles. Since Section 1346's honesty requirement fails to provide any defined standards of conduct that citizens are required to meet, the statute should be declared unconstitutionally vague and sent back to Congress. On December 8, 2009 at the oral arguments in *Black* and *Weybrauch* before the Supreme Court, we expect to get the first indications of whether the Supreme Court agrees.

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First Circuit's *Textron* Ruling Raises New Concerns about Vitality of Work-Product Doctrine

In August 2009, the First Circuit *en banc* ruled on the applicability of the work-product doctrine to shield tax accrual work papers from an IRS summons. *United States v. Textron, Inc.*, 577 F.3d 21 (1st Cir. 2009). In a decision widely criticized in the accounting industry and by others such as the Association of Corporate Counsel of America (ACCA), the court held that work-product protection did not apply. In the context of internal corporate investigations, *Textron* raises new concerns about discovery by government authorities of counsels' assessments of liabilities that might arise from possible misconduct discovered by businesses in the course of operations.

Background

In 2001, *Textron* participated in nine sale-in, lease-out (SILO) transactions, which the IRS considers to be abusive "listed transactions." *Textron's* in-house tax attorneys analyzed the company's tax positions, and its in-house audit personnel, in consultation with counsel, prepared tax accrual work papers. The work papers included a spreadsheet listing the issues, percentage estimates of the hazards of litigation, and established a tax reserve. *Textron* disclosed the tax accrual work papers to its external auditors, Ernst & Young (E&Y), with the understanding that they were confidential. It did not allow E&Y to retain copies.

The IRS commenced an audit of *Textron* and became aware of the SILO transactions. Under IRS policy, the Service (1) seeks tax accrual work papers specifically related to a taxpayer's participation in a listed transaction if the taxpayer engaged in a single listed transaction and properly disclosed its participation; and (2) seeks all tax accrual work papers if the taxpayer engaged in multiple listed transactions or in a single listed transaction that was not properly disclosed. Because *Textron* engaged in nine SILOs, the IRS issued summonses for all of *Textron's* tax accrual work papers for 2001. *Textron* declined to produce

them, claiming work-product protection, and the IRS moved to enforce the summons.

The district court found for Textron, agreeing with the defense that the disclosure was not a waiver of the work-product doctrine as defined by Fed. R. Civ. Pro. 26(b)(3). According to the district court, only disclosures inconsistent with the adversary system are deemed waivers of the work-product protection. Typically, this means disclosure to an adversary, which E&Y was not. Applying the First Circuit's "because of litigation" test, the lower court concluded the tax accrual work papers qualified for the doctrine's protection because of the prospect of litigation, even if the documents also had a dual business purpose. *Maine v. United States Dep't of the Interior*, 298 F.3d 60, 68 (1st Cir. 2002).

On appeal to the First Circuit, the IRS argued that the presence of a business or regulatory purpose defeated work-product protection. The IRS claimed that the tax accrual work papers were not prepared because of litigation since they were created to evaluate uncertain tax positions for financial accounting purposes. The First Circuit initially rejected this IRS argument and affirmed the district court's holding that documents could be protected even though there was a dual purpose. After all, as the panel noted, they would not have been prepared for financial accounting purposes if there had been no prospect of litigation with the IRS. This decision was vacated, however, and the case was heard *en banc* by the First Circuit.

En Banc Ruling in *Textron*

In its *en banc* opinion, the First Circuit vacated the panel's ruling. The First Circuit held that the work papers were not protected pursuant to the work-product doctrine under the First Circuit's established "because of litigation" test. The court rejected the argument that providing the IRS with the company's evaluation of its legal position was unfair, observing that that "tax collection is not a game" and that under-reporting of corporate taxes "is likely endemic." The court ultimately found the work-product doctrine is aimed at protecting work done for litigation, not in preparing financial statements. Since Textron's work papers were to support financial filings and gain auditor approval, the IRS had rightful access.

For the dissent, the majority's decision was out of step with both circuit precedent and the plain language Rule 26. See e.g., *United States v. Adlman*, 134 F.3d 1194, 1198-99 (2d

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Cir. 1998) (holding that a memorandum discussing various legal issues relating to taxation and predicting the outcome of possible litigation prepared in connection with the sale of a subsidiary could qualify as work product). Chiding the majority for favoritism toward the IRS, the dissent complained that "the scope of the work-product doctrine should not depend on what party is asserting it." Perhaps most importantly, however, the dissent noted that "under the majority's rule one party in a litigation will be able to discover an opposing party's analysis of the business risks of the instant litigation, including the amount of money set aside in a litigation reserve fund, created in accordance with similar requirements as Textron's tax reserve fund."

Analysis

In *Textron*, the First Circuit applied its "because of litigation" test narrowly in defining the reach of work-product protection under Rule 26 in connection with audit work papers. *Textron* follows the Fifth Circuit's similar ruling many years ago in *United States v. El Paso Co.*, 682 F.2d 530, 542 (5th Cir. 1982), cert. denied, 466 U.S. 944 (1984) (finding tax accrual work papers are only protected by the work-product doctrine if the documents are "primarily motivated to assist in future litigation"). After *Textron*, there is arguably little difference other than nomenclature between the First Circuit's "because of litigation" test and the Fifth Circuit's old "primary purpose" standard.

The *Textron en banc* ruling should be carefully considered by counsel when consulting with auditors regarding possible loss contingencies. Work papers reflecting statements of counsel and the resulting establishment of a specific reserve in connection with a possible specific claim may not be protected under the work-product doctrine and may constitute highly damaging admissions of a

party opponent under F.R.E. 801 admissible in court. The problems with allowing adversaries to discover such matters in connection with litigation and to admit resulting evidence at trial are so obvious as to need no elaboration. It seems hard to argue with ACCA's position that *Textron* fails to recognize that greater protection, not less, is needed to support candid attorney-client communications and to cabin discovery by adversaries of attorney work-product.

To the extent that *Textron* reflects the First Circuit's view that work-product is entitled to less protection when law enforcement interests are engaged, *Textron* is a particularly ominous decision for lawyers, accountants and their clients in defending regulatory proceedings and criminal cases. Counsel conducting internal corporate investigations of possible misconduct are urged to review and consider *Textron*, as well as the Financial Accounting Standards Board's proposed changes to Financial Accounting Standards Statement 5 relating to financial statement reporting of loss contingencies, before consulting company's management and the company's audit personnel regarding the results of their inquiries.

With any luck, neither *Textron's* reasoning nor result will be adopted in other circuits. In the absence of any relief

from *Textron*, the best approach for affected parties is to be mindful of the record they may have to present in support of future claims of work-product protection. Accordingly, both in-house and outside counsel involved in internal investigations, as well as those involved in considering possible loss contingencies, should take measures to document and support that their work was done "in anticipation of litigation" under Rule 26.

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