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Headnote

Risk Assessments

STEVEN A. MEYEROWITZ

The worldwide recession is not only impacting the way many companies pursue business opportunities, but also is having an adverse impact on the compliance function due to headcount reductions stemming from cost cutting measures and tighter budgets for implementing compliance programs. As a relatively fixed number of competitors chase an ever shrinking number of opportunities, many companies will be far more aggressive about how they go after contracts and affected employees may be more apt to cut corners on compliance in order to secure new business opportunities. As pointed out by Jeffrey T. Harfenist, a Managing Director with Navigant Consulting (and a member of the Board of Editors of the *Financial Fraud Law Report*), and Saul M. Pilchen, a partner in the Government Enforcement Litigation Group at Skadden, Arps, Slate, Meagher & Flom LLP, in their article, "Anti-Corruption Risk Assessments: A Primer for General Counsels, Internal Auditors, and Other Compliance Personnel," when such business practices are considered against the backdrop of a resource constrained anti-corruption watchdog function — a potentially dangerous confluence of factors emerges.

Messrs. Harfenist and Pilchen suggest, however, that a robust compliance regime can go a long way toward establishing the company's "intent" to follow the law even in the event a rogue employee succumbs to temptation to cut corners by engaging in corrupt conduct. Thus, the authors believe, while it is clear that designing, implementing and testing an effective anti-corruption program is not without its challenges and often requires the expenditure of limited resources in the face of budgetary constraints, companies that diminish or ignore the importance of this critical function can substantially increase their anti-corruption risk. In consider-

ing what level of investment to make in compliance programs, the authors of this article conclude that companies should be mindful that the U.S. government officials recognize the current economic climate and are considering it in their enforcement approach.

Lifting the Veil of Asset Protection

The newest member of our Board of Editors is David J. Cook, the founding partner of Cook Collection Attorneys in San Francisco who focuses his practice on commercial collections; creditors' rights in the enforcement of judgments; recovery of claims based upon forgery and mishandling of negotiable instruments; fraudulent conveyances; and creditor representation in bankruptcy cases. Mr. Cook is the author of our next article, "Lifting the Veil of Asset Protection: Strategies to Uncover Hidden and Secreted Assets Through the Development of Tent Pole Jurisdiction." Simply stated, this article is a judgment creditor's roadmap to recovery.

And More…

Among the other articles in this issue is one we would like to particularly highlight: "Wiretaps and Undercover Sting Operations: Are White Collar Defendants Ready?" Here, Mark B. Sheppard and Ryan Anderson of Montgomery, McCracken, Walker & Rhoads, LLP, explain that the expansion of surveillance and sting operations into new areas of criminality reflects a shift in resources and attitudes toward white collar crime. In the authors' view, as the Department of Justice melds the expertise it has in prosecution of these cases, the defense bar must step up its game to properly defend these types of cases.

Enjoy the issue!

Steven A. Meyerowitz
Editor-in-Chief
October 2010

Anti-Corruption Risk Assessments: A Primer for General Counsels, Internal Auditors, and Other Compliance Personnel

JEFFREY T. HARFENIST AND SAUL M. PILCHEN

The authors recommend a series of protocols that companies should consider instituting in their efforts to evaluate and strengthen their global anti-corruption compliance programs, with particular emphasis on risk assessments tailored efficiently to the business models, competitive landscapes, customer bases, and commercial relationships at issue.

As anti-corruption laws, regulations and enforcement continue to strengthen around the globe, the risks for businesses with a global footprint have never been greater. Recent comments by officials at the Department of Justice ("DOJ") and the Securities and Exchange Commission ("SEC") have put companies and individuals on notice that

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Jeffrey T. Harfenist, CPA, MBA, a member of the Board of Editors of the *Financial Fraud Law Report*, is a Managing Director with Navigant Consulting.His practice focuses on anti-corruption matters, specifically on reactive engagements pursuant to a government subpoena, and proactive compliance reviews. Saul M. Pilchen, a partner in the Government Enforcement Litigation Group at Skadden, Arps, Slate, Meagher & Flom LLP, is a former federal prosecutor who defends corporations, officers, directors, and employees in a wide range of criminal and related civil and administrative enforcement matters, conducts internal investigations and risk assessments, and assists clients in implementing and enhancing their compliance programs. The authors can be reached at jeff.harfenist@navigantconsulting.com and saul.pilchen@skadden.com, respectively.

corruption, in any form, will not be tolerated. This past May in Paris, Attorney General Eric Holder told his audience at the Organisation for Economic Co-Operation and Development ("OECD") that when it comes to the Foreign Corrupt Practices Act ("FCPA"):

> prosecuting individuals is a cornerstone of our enforcement strategy because, as long as it remains a tactic, paying large monetary penalties cannot be viewed by the business community as merely "the cost of doing business."[1]

With the formation of dedicated teams to proactively investigate potential violations of the FCPA, the U.S. government has demonstrated its commitment to an aggressive enforcement policy.[2] Also this past May, when speaking at the fifth annual *Compliance Week* conference, Lanny Breuer, the Assistant Attorney General who heads the Criminal Division, stated that the DOJ's enforcement budget for 2010 and 2011 will be increased substantially due to the hiring of additional prosecutors and support staff.[3]

However, the focus of regulatory agencies is not confined within U.S. borders. In April 2010, the United Kingdom passed a comprehensive Bribery Act which contained exacting requirements affecting the manner in which companies conduct business.[4] Additionally, other international law enforcement organizations are sending a similar message to companies operating in their jurisdictions on their determined effort to combat international corruption and bribery within their borders.[5]

As anti-corruption legislation continues its move to the forefront around the world, cross-border cooperation in these investigations is becoming the norm.[6] The cost of non-compliance is substantial as authorities now question not only what explicit controls and policies were in place for detecting and preventing FCPA violations, but what specific steps senior management adopted to mitigate the company's risk of violating anti-corruption laws.

The first step for the company in addressing these questions is instituting a comprehensive compliance program to mitigate the risk of violating the ever broadening array of regulatory enforcement and oversight measures.[7] In our experience, conducting an anti-corruption risk assess-

ment is a cost effective yet key component of an effective compliance program and will further help the company mitigate risk by testing the effectiveness of the company's anti-corruption policies and procedures. Such an assessment will help identify potential weaknesses and areas of risk and exposure, and the company can then take steps to resolve these weaknesses and areas of concern before they become law enforcement or derivative litigation issues in the future. Risk assessments are critical in demonstrating — whether to the board of directors, plaintiffs' lawyers, or law enforcement personnel — that a company is taking a proactive approach to compliance.[8]

APPROACHING ANTI-CORRUPTION COMPLIANCE

The balance of this article focuses on a series of protocols companies should consider instituting in their efforts to evaluate and strengthen their global anti-corruption compliance programs, with particular emphasis on the risk assessment.[9] Some of the principal areas on which to focus include:

- Performing a targeted assessment that identifies anti-corruption compliance risk;
- Evaluating the effectiveness of anti-corruption compliance policies, procedures, and controls in place, as well as the content of various training regimens;[10]
- Assessing the degree to which current accounting controls are compliant with the books and records provision of the FCPA and other pertinent laws under which the company operates;[11]
- Uncovering high risk relationships with government officials and other third parties;
- Conducting targeted interviews of procurement and government affairs employees to identify control weaknesses and potential instances of non-compliance;
- Detecting unusual transactions that increase exposure to corruption;
- Evaluating how well anti-corruption testing is incorporated into the internal audit function;

- Understanding how an incentive compensation system exacerbates anti-corruption risk;
- Identifying gaps in the existing control environment and developing and/or augmenting appropriate accounting controls to further minimize the risk of illegal payments; and
- Providing internal audit and compliance professionals with the knowledge and tools necessary to monitor the company's compliance with stated policies and protocols.

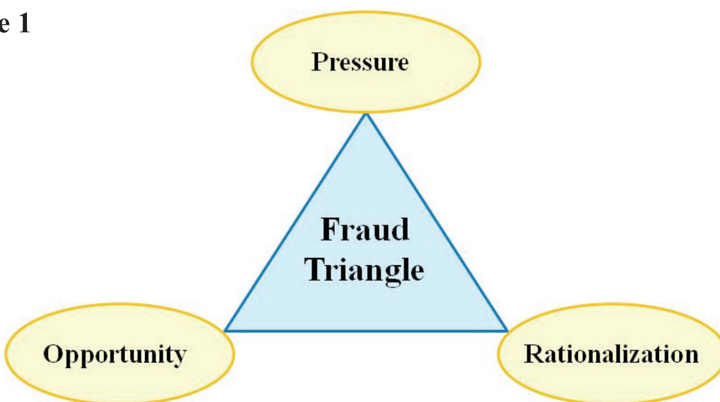
The focus of the discussion that follows addresses the iterative, proactive components of a compliance risk-based testing program.[12]

Risk Assessment

Companies looking to evaluate their overall compliance program should consider employing a phased, risk-based approach to ensure that resources are spent judiciously and return the highest value. The process of assessing risk is complex and considers a number of qualitative and quantitative factors and analyses.

Before applying any initial analytical procedures, the company should identify pressure points being exerted by both internal forces and external constituencies. As illustrated in Figure 1, the Fraud Triangle[13] posits that

Figure 1



gaining insights into the numerous pressures a company is subject to is a necessary first step in identifying the range of fraud risks that are present and inserting controls that reduce the opportunities for adverse behaviors. Once each of the pressure points, to which the company and its employees is subject, is understood, management will be in a better position to implement a series of forensic protocols designed to uncover whether individuals with the opportunity to alleviate the pressures are doing so and, as a result, are exposing the company to substantial risk.

To properly assess and understand the assortment of pressures to which a company and its employees may be subject (and the associated risk) one should gain a deep understanding of a range of issues, including (but not limited to) competitors and geographic locations, market forces shaping the industry, history of anti-corruption violations within the industry, strategic initiatives the company is undertaking (including acquisitions and joint ventures), the performance of various product lines, region-specific cultural issues,[14] and macro events impacting the company's operations, such as global economic stresses and regional regulatory or enforcement developments. Several specific risk areas which may be present include:

1. *Acquisitions:* How acquisitive has the company been, and what is the expectation for acquisitions on a go forward basis? Conducting targeted analytical procedures and pre-acquisition reputational due diligence and post-acquisition monitoring can help the company avoid acquiring a costly and disruptive FCPA liability.[15] For recent acquisitions, the company can perform a post-closing, deep dive into the acquisition's detailed financial data to identify transactions and relationships that warrant further attention.[16]
2. *Competitive Landscape:* Are there factors unique to the business sector(s) in which the company operates that exert significant performance pressures on government relations personnel and sales and product line managers? The intensely competitive nature of the company's markets, coupled with relatively short product life cycles and pricing pressures associated with key product lines, may result in the payment of bribes in order to obtain or retain business or other competitive advantage. In addition, have competitors had recent anti-

corruption related exposure? If so, this would not only have the unfortunate effect of increasing law enforcement scrutiny on the company, and others operating in that business sector, but also raises the question of how the company is competing for and winning opportunities without running afoul of governing statutes if key competitors are known for paying bribes.[17]

3. *Strong International Growth:* Has the company been experiencing significant and/or rapid international growth? If so, where has the growth been and have the appropriate controls and policies — especially those concerning the use of agents and other channel partners — kept pace with this growth in order to mitigate the risks of illegal business practices?

4. *Customer Base:* In overseas markets, the likelihood of the company dealing with what the U.S. government considers a "foreign government official" — essentially any political representative or employee of a state-owned or controlled entity — increases exponentially.[18] Utilizing forensic protocols such as targeted review in these locations of contracts, round number payments, and use of petty cash can assist in analyzing this potential risk, leading to the development of country-specific processes to mitigate compliance risk.

5. *Use of Agents and Other Third Party Channels:* In many developing economies it is necessary or desirable to employ third parties to assist with the development and closing of sales opportunities. From a risk perspective, questions to ask include: How pervasive is the use of agents and sales intermediaries? Who presented the business cases in favor of these intermediaries, and who evaluated those business cases to see whether they made sense? Does the company conduct pre-retention due diligence on third parties? Does the company have the ability to perform "look through" audits of its agents and sales intermediaries? If so, has the company done so and what have been the findings? Utilizing forensic tools can assist in analyzing this potential risk in the use of third party agents and sales intermediaries.[19]

6. *Internal Control Deficiencies:* Companies should consider the findings from previous audits, surveys or transactional testing to help

evaluate risk. Control weaknesses — especially those in the procure-to-pay cycle — should be of particular concern. However, it is important to note that even companies with strong control environments are at risk due to the increasing incidence of collusive behavior between insiders.

7. *Adverse Metrics:* Companies should evaluate which of the company's key metrics followed by the analyst community — if any — have been declining. In addition, from an internal perspective, consider what has been the relative performance of operating groups and business units on a budget versus actual basis. Once these pressure points are understood, analytical procedures should be focused on identifying and mitigating behaviors associated with these risks.

8. *Incentive Compensation:* Understanding how people are paid is a critical step in understanding what actions individuals may take to drive their compensation that are contrary to the company's stated anti-corruption policies. A fundamental tenet of most fraud investigations is that compensation drives behavior.[20] In our practices, we are beginning to see the use of compliance-related factors to influence individual compensation decisions, as well as the more traditional performance criterion of financial success.

While this is by no means a comprehensive list of the pressure points and risks inherent in any company's operations, it is illustrative of the process that should be employed in conducting a comprehensive risk analysis.

Interviews and Data Review/Gap Analysis

The next two evaluative steps in the compliance risk assessment are interrelated and provide critical information regarding what controls, if any, are weak or are being circumvented by company insiders. In those entities where a strong control environment exists, but collusive behavior is present, a false sense of security is created. Companies should consider utilizing experts in internal controls and individuals who are adept at extracting vital information from company personnel through interviews to help identify gaps in the existing control environment, and whether indi-

viduals may be colluding to purposefully by-pass existing procedures and controls.

Forensic Analysis

With the overwhelming amount of historical data companies keep on hand it is critical to utilize forensic tools that can efficiently mine the company's databases looking for transactions that require further analysis. These tools allow the users to efficiently analyze enormous amounts of data in order to identify:

- **Potentially Anomalous Transactions**: These transactions, which are designed to "hide in plain sight," represent a miniscule percentage of the overall transaction volume but can potentially expose the company to significant liability. Forensic tools are available to search for transactions that have specific fraud-related attributes, as well as those that fall outside the company's "norm" based upon historical patterns. Examples of such transactions include round number payments, "spikes" in the use of travel and entertainment budgets and petty cash, and bookings in obscure ledger accounts. The benefit of such forensic tools is that they efficiently mine through disparate data sets, uncovering transactions that possess high indicia of fraud and thereby providing much "bang for the buck" in the context of the risk assessment review.
- **High Risk Relationships**: High risk relationships include entities with whom the company is doing business, where a company employee has an undisclosed relationship or with entities that otherwise pose a high corruption risk. To mitigate such risk, the company might consider employing forensic tools designed to "risk rank" commercial relationships through a system of complex rules. Some of the issues of concern might include the identification within an organization's vendor master file of red flags that are triggered by indicia of high risk characteristics or attributes, including:
  - Politically Exposed Persons ("PEPs") or a close relative or associate;
  - Instances in which a third party has been involved in an SEC

or DOJ investigation into possible violations involving fraud, bribery or the like; and

– State-owned Enterprises.

In addition, consideration should be given to cross-referencing the Office of Foreign Assets Control Specially Designated Nationals ("OFAC SDN") list, U.S. Bureau of Industry and Security – Denied Persons List, the World Bank Listing of Ineligible Firms, and cases in which third parties have been the subject of government settlements or prosecutions (not merely investigations) involving fraud or corruption.

Targeted Testing

Based upon the information gathered in each of the previous steps, the company could then select a group of transactions for testing — the majority having some identifiable risk associated with them — as well as a smaller set of random transactions from data sets that have high risk attributes (i.e., entertainment, travel, gifts, honorariums, & customs). Once a set of transactions has been identified, the company would review all of the pertinent documentation surrounding the population of transactions selected and evaluate those transactions on a number of relevant criteria.

THE END RESULT

Should the company embark on the analyses discussed in this article, the byproducts of the process described above might include:

- Identification of potential instances of non-compliance, so that the company can implement necessary remediation on a timetable, and with corresponding expenditures of resources, set internally rather than at the behest of a regulator or law-enforcement personnel;
- An evaluation of the company's compliance function, including an analysis of its anti-corruption policies and procedures, an exception report on compliance with stated policies, and the level of "buy in" by management;

- Both long- and short-term proposals for augmenting the existing control environment to minimize the risk of implicating the FCPA as well as other applicable global anti-corruption laws;
- Suggestions for improving/augmenting the qualitative nature of the data being captured which will allow both internal audit and other investigative professionals to effectively employ forensic tools to identify on a timely basis high risk relationships and transactions;
- A risk ranking of third parties (including joint venture partners, vendors, agents, channel partners, brokers, freight forwarders, contractors, consultants, accountants, and lawyers) with whom the company is doing business, particularly abroad;
- A consideration of training regimens for new employees with regard to the company's anti-corruption policies and procedures, as well as periodic "refresher" or updated training supplements for specific employees;
- Targeted training regimens for members of the company's internal audit team, and implementation of supplemental audit protocols, to help them monitor on-going anti-corruption compliance efforts;
- An evaluation of the company's compliance with the books and records provision of the FCPA; and
- An analysis of the anti-corruption risks associated with recent acquisitions.

Careful consideration should be given to the form and content of any written reports or formal presentations to senior management, the audit committee, or board of directors containing risk assessment findings, due to critical issues concerning privilege and disclosure. In this regard, we believe it is advisable to consult with outside counsel before designing and conducting any type of program-wide evaluation.

CONCLUDING THOUGHTS

The worldwide recession is not only impacting the way many companies pursue business opportunities, but also is having an adverse impact on

the compliance function due to headcount reductions stemming from cost cutting measures and tighter budgets for implementing compliance programs. As a relatively fixed number of competitors chase an ever shrinking number of opportunities, many companies will be far more aggressive about how they go after contracts and affected employees may be more apt to cut corners on compliance in order to secure new business opportunities. When such business practices are considered against the backdrop of a resource constrained anti-corruption watchdog function — a potentially dangerous confluence of factors emerges.

To the contrary, a robust compliance regime can go a long way toward establishing the company's "intent" to follow the law even in the event a rogue employee succumbs to temptation to cut corners by engaging in corrupt conduct. Thus, while it is clear that designing, implementing and testing an effective anti-corruption program is not without its challenges and often requires the expenditure of limited resources in the face of budgetary constraints, companies that diminish or ignore the importance of this critical function can substantially increase their anti-corruption risk. In considering what level of investment to make in compliance programs, companies should be mindful that the U.S. government officials recognize the current economic climate and are considering it in their enforcement approach.[21]

NOTES

[1] Eric H. Holder, Jr., U.S. Attorney Gen., Attorney General Holder Delivers Remarks at the Organisation for Economic Co-Operation and Development (May 31, 2010).

[2] In June 2010, John Webster Warwick, the former President of Ports Engineering Consultants Corporation ("PECC"), was sentenced to 37 months in prison resulting from his February 2010 guilty plea to one count of conspiring to make corrupt payments to foreign government officials in Panama in violation of the Foreign Corrupt Practices Act. Press Release, U.S. Dep't of Justice, Virginia Resident Sentenced to 37 Months in Prison for Bribing Foreign Government Officials (June 25, 2010) *at* http://www.justice.gov/opa/pr/2010/June/10-crm-750.html; *United States v. Warwick*, No. [3]:09CR449 (E.D. Va. Dec. 15, 2009). In a related case, Charles Jumet, the former Vice President and then later President of PECC, pleaded guilty to two criminal counts charging

him with conspiring to make corrupt payments to foreign officials and was sentenced to 87 months in prison and ordered to pay a fine. *United States v. Jumet*, No. 09-CR-00397 (E.D. Va. Nov. 10, 2009). In fact, over 20 individuals have been charged by the DOJ in the first half of 2010.

[3] Lanny A. Breuer, Assistant Attorney Gen., Criminal Div. of the U.S. Dep't of Justice, Prepared Remarks to Compliance Week 2010 — 5th Annual Conference for Corporate Financial, Legal, Risk, Audit & Compliance Officers (May 27, 2010).

[4] Taking the FCPA several steps further, the Bribery Act criminalizes both commercial bribery and bribery of domestic and foreign government officials. However, unlike the FCPA, it does not contain a books and records provision, fails to make an exception for facilitating payments, and does provide for a defense if the target of the investigation can demonstrate that it has "adequate procedures" in place to detect and prevent behaviors that the Act prohibits. While it has yet to be determined what constitutes "adequate procedures," this provision does appear to recognize favorably those companies that have demonstrated continuing efforts to implement, test and strengthen their anti-corruption compliance programs. Although the Act was adopted in April 2010, the United Kingdom recently announced it would delay implementation until April 2011. Press Release, U.K. Ministry of Justice, Bribery Act Implementation (July 20, 2010) *at* http://www.justice.gov.uk/news/newsrelease200710a.htm.

[5] *See e.g.*, Claudio Gatti, *Alstom at Center of Web of Bribery Inquiries*, N.Y. Times (Mar. 29, 2010), *available at http://www.nytimes.com/2010/03/30/business/global/30alstom.html* (discussing investigations and inquiries throughout the world, including in Australia, Europe, South America, and the United States).

[6] *See e.g.*, Press Release, U.S. Dep't of Justice, Siemens AG and Three Subsidiaries Plead Guilty to Foreign Corrupt Practices Act Violations and Agree to Pay $450 Million in Combined Criminal Fines (Dec. 15, 2008) *at* http://www.justice.gov/opa/pr/2008/December/08-crm-1105.html (discussing how Siemens paid $1.6 billion in global penalties to U.S. and German authorities and stating how the U.S. and German authorities worked closely together on their respective cases against Siemens); Press Release, U.S. Dep't of Justice, Two U.K. Citizens Charged by United States with Bribing Nigerian Government Officials to Obtain Lucrative Contracts as Part of KBR Joint Venture Scheme (Mar. 5, 2009) *at* http://www.justice.gov/opa/pr/2009/

March/09-crm-192.html (crediting the arrest of two U.K. citizens, who were indicted by the U.S. government for their part in the KBR joint venture scheme, to the London Metropolitan Police, at the request of the United States); Press Release, U.S. Dep't of Justice, AGCO Corp. to Pay $1.6 Million in Connection with Payments to the Former Iraqi Government Under the U.N. Oil-for-Food Program (Sept. 30, 2009) *at* http://www.justice.gov/opa/pr/2009/September/09-crm-1056.html (discussing the cooperation between the U.S. and Danish authorities in the AGCO Corp. case); Press Release, U.S. Dep't of Justice, Innospec Inc. Pleads Guilty to FCPA Charges and Defrauding the United Nations; Admits to Violating the U.S. Embargo Against Cuba (Mar. 18, 2010) *at* http://www.justice.gov/opa/pr/2010/March/10-crm-278.html (listing Innospec as a "[c]oordinated [g]lobal enforcement action by DOJ, SEC, OFAC and United Kingdom's Serious Fraud Office").

[7] The Federal Sentencing Guidelines for Organizations (the "Guidelines"), which guide the criminal sentencing of companies and other entities convicted of violating criminal laws, provide an incentive for companies to adopt comprehensive compliance programs by providing for a reduced punishment if "the organization had in place at the time of the offense an effective compliance and ethics program." U.S. Sentencing Guidelines Manual § 8C2.5(f)(1) (2009).

[8] Such risk assessments are an integral part of an enhanced compliance process, as evidenced by the recent Organisation for Economic Cooperation and Development (the "OECD") Recommendation of the Council for Further Combating Bribery of Foreign Public Officials in International Transactions (the "OECD Recommendation"). The OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions (the "OECD Anti-bribery Convention") was implemented by the United States in 1998 and resulted in an amended and strengthened FCPA. On November 26, 2009, an OECD working group adopted the OECD Recommendation, which was released on December 9, 2009. The OECD Recommendation notes that "[e]ffective internal controls, ethics, and compliance programmes or measures for preventing and detecting foreign bribery should be developed on the basis of a risk assessment addressing the individual circumstances of a company, in particular the foreign bribery risks facing the company (such as its geographical and industrial sector of operation). Such circumstances and risks should be regularly monitored, re-assessed, and adapted as necessary to ensure the continued effectiveness of the company's internal

controls, ethics, and compliance programmes or measures." Organisation for Economic Cooperation and Development, "Recommendation of the Council for Further Combating Bribery of Foreign Public Officials in International Business Transactions," Annex II (Nov. 26, 2009), *available at* http://www.oecd.org/dataoecd/11/40/44176910.pdf. The DoJ has said that this additional guidance in the OECD Recommendation comes with the endorsement of the U.S. government. David Hechler, "Roided Up Enforcement: DOJ Unit That Prosecutes FCPA to Bulk Up Substantially," Corporate Counsel (Feb. 25, 2010), http://www.law.com/jsp/cc/PubArticleCC.jsp?id=1202444478279 (last visited July 22, 2010) (reporting on Mark Mendelsohn's comments at the Global Ethics Summit 2010 in New York City).

[9] The essential elements for an effective anti-corruption compliance program can be derived from various sources, including the Guidelines, the proposed amendments to the Guidelines, prior enforcement actions and Opinion Releases by the Department of Justice, the Principles of Federal Prosecution of Business Organizations in the United States Attorneys' Manual, and the OECD Recommendation.

[10] The Guidelines highlight the importance of this evaluation by stating that a company must "evaluate periodically the effectiveness of the organization's compliance and ethics program." U.S. Sentencing Guidelines Manual § 8B2.1(b)(5)(B) (2009). While the concept of conducting risk assessments has long been included in the Guidelines, the proposed amendments to the Guidelines further emphasize the importance of organizations conducting periodic risk assessments. United States Sentencing Commission, Notice of Proposed Amendments to Sentencing Guidelines, Policy Statements, and Commentary, 75 Fed. Reg. 3525 (Jan. 21, 2010) (listing proposed amendment § 8B2.1(c), which states that an "organization shall periodically assess the risk of criminal conduct and shall take appropriate steps to design, implement, or modify each requirement set forth in subsection (b) to reduce the risk of criminal conduct identified through this process").

[11] The FCPA requires issuers of securities that trade on exchanges in the United States to "make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of assets of the issuer." Foreign Corrupt Practices Act, 15 U.S.C. § 78m(b)(2)(A) (2006). The FCPA goes on to state that with regard to internal controls, that the issuer "devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that" (1) transactions are executed

in accordance with management's authorization; (2) transactions and assets are recorded as necessary to permit the preparation of financial statements and maintain accountability for assets; (3) access to assets is permitted subject to management's authorization; and (4) recorded assets are compared to existing assets at suitable intervals and appropriate actions are taken with respect to any differences noted. 15 U.S.C. § 78m(b)(2)(B).

[12] Taking a proactive approach to testing a compliance program is essential because the United States Attorneys' Manual guides prosecutors to "attempt to determine whether a corporation's compliance program is merely a 'paper program' or whether it was designed, implemented, reviewed, and revised as appropriate, in an effective manner." U.S. Dep't of Justice, United States Attorneys' Manual 9-28.800 (2008), *available at* http://www.justice.gov/usao/eousa/foia_reading_room/usam/title9/28mcrm.htm. Such considerations "will enable the prosecutor to make an informed decision as to whether the corporation has adopted and implemented a truly effective compliance program that…may result in a decision to charge only the corporation's employees and agents or to mitigate charges or sanctions against the corporation." *Id.*

[13] The concept of a "Fraud Triangle" is discussed in "Statement on Auditing Standards No. 99 (SAS 99), Consideration of Fraud in a Financial Statement Audit."

[14] For example, in China the prevalence of gifts, as well as other "business courtesies," play a critical role in Chinese commerce, and are notably different than the environment found in other countries. It is these types of nuanced, yet essential qualitative factors, which must be considered when designing, implementing and testing the company's compliance program.

[15] *See e.g.*, *United States v. Latin Node, Inc.*, No. 09-20239-CR (S.D. Fla., Apr. 3, 2009) (providing an example of an acquired company pleading guilty to FCPA violations that were discovered after closing of the acquisition).

[16] *See e.g.*, U.S. Dep't of Justice, Foreign Corrupt Practices Act Review Opinion Procedure Release No. 08-02 (June 13, 2008), *available at* http://www.justice.gov/criminal/fraud/fcpa/opinion/2008/0802.pdf (providing guidance on how a company might approach an acquisition that would involve performing post-closing due diligence on the acquired company).

[17] The oil and gas industry and the pharmaceutical and medical device industry are two industries that have been targeted by the U.S. government in its enforcement efforts. Lanny A. Breuer, Assistant Attorney Gen., Criminal Div.

of the U.S. Dep't of Justice, Prepared Keynote Address to The Tenth Annual Pharmaceutical Regulatory and Compliance Congress and Best Practices Forum (Nov. 12, 2009) (announcing that the pharmaceutical industry will now be a focus for FCPA enforcement efforts). The oil and gas industry has seen multiple related FCPA investigations in the last few years flowing from the guilty pleas by several Vetco entities and the subsequent announcement by Panalpina, a worldwide logistics provider, of a comprehensive review by U.S. authorities of its business practices in Nigeria and other countries. *See, e.g, United States v. Vetco Gray Controls, Inc.*, et al, No. CR-H-07-004 (S.D. Tex., filed Jan. 5, 2007); *see also* Press Release, Panalpina, Panalpina Investigates Business Practices in Certain Countries (July 24, 2007) *at* http://www.panalpina.com/www/global/en/media_news/news/newsarchiv_ordner/07_07_24.print.html. In November 2009, Breuer indicated that the U.S. government will continue to focus on industries and geographical areas where it can have the greatest effect on reducing bribery. Lanny A. Breuer, Assistant Attorney Gen., Criminal Div. of the U.S. Dep't of Justice, Prepared Address to the 22nd National Forum on the Foreign Corrupt Practices Act (Nov. 17, 2009). Therefore, companies should consider whether their competitors have been targeted by the U.S. government's enforcement efforts.

[18] In November 2009 at the Tenth Annual Pharmaceutical Regulatory and Compliance Congress and Best Practices Forum, Breuer highlighted this risk by discussing individuals that constitute a "foreign official" in the pharmaceutical industry. Breuer noted that individuals in the health ministry of a foreign country are easy to identify as foreign officials but that less obvious individuals may include physicians and other healthcare professionals employed by state-owned entities. *Id.* (stating that "it is entirely possible, under certain circumstances and in certain countries, that nearly every aspect of the approval, manufacture, import, export, pricing, sale and marketing of a drug product in a foreign country will involve a 'foreign official' within the meaning of the FCPA"). In 2002, Syncor Taiwan, Inc. pled guilty to violating the FCPA and paid a two million dollar fine in connection with improper payments to doctors at state-owned hospitals, who were considered "foreign officials" under the FCPA, for the purpose of obtaining and retaining business. *United States v. Syncor Taiwan, Inc*., Cr. No. 02-01244 (C.D. Cal., filed Dec. 12, 2002).

[19] The *Baker Hughes* case provides an example of how companies can get in trouble for the actions of their agents. Baker Hughes Services International

Inc. ("BHSI"), a wholly owned subsidiary of Baker Hughes Inc., pled guilty in April 2007 to violating the FCPA. BHSI admitted to using a consulting firm, retained as a third-party agent, as a conduit for making corrupt payments to Kazakh officials. In the end, Baker Hughes paid $44 million in combined penalties and fines. *See United States v. Baker Hughes Serv. Int'l*, No. H-07-129 (S.D. Tex. filed Apr. 11, 2007); *SEC v. Baker Hughes Inc. and Roy Fearnley*, Civil Action No. H-07-1408, (S.D.Tx., filed April 26, 2007).

[20] With the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act, companies may also see that promises of compensation may drive their employees to report information about their employers regarding potential violations of the FCPA to the U.S. government. Specifically, Section 922(a) of the act states that the SEC shall provide whistleblower awards for "original information" that leads to a successful enforcement action. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. (2010). As a result, companies need to stay on top of potential instances of non-compliance because employees with a potential stake in reporting these issues may lead to an increased likelihood that they will more keenly watch out for them.

[21] During his address to the 22nd National Forum on the FCPA in November 2009, Breuer cautioned that the "Department is looking carefully at lapses — both past, present, and future — in corporate compliance as a result of the down turn in the global economy." Prepared Address to the 22nd National Forum on the Foreign Corrupt Practices Act, *supra* note 11. Breuer also stated, "The importance of our efforts is only heightened in the current economic climate, one in which bribery in international markets offers a quick fix to the problem of a smaller pool of business opportunities, and in which corporate executives may be temped both to look the other way and to invest fewer resources in their compliance efforts." *Id.*

Lifting the Veil of Asset Protection: Strategies to Uncover Hidden and Secreted Assets Through the Development of Tent Pole Jurisdiction

DAVID J. COOK

This article is the judgment creditor's roadmap to recovery.

THE CALL

"What assets does your judgment debtor have?" queries the attorney.
"No clue," replies the prospective client.[1]

THE CHALLENGE

A judgment entitles the judgment creditor to use force, authorized by law, to seize property from the debtor and compel its liquation to produce sufficient cash to pay the judgment.[2] The writ of execution and sheriff's sale, turnover order, or post-judgment receiver are the remedies to reach the assets of a debtor. If the judgment debtor operates a going business, owns valuable real property in its own name, or has other visible assets,

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judgment creditors can use these traditional forms of post-judgment process to reach these known assets.

Not all debtors have readily known assets, and many debtors hide or secrete assets, cloak them in the name of others (such as family members, corporations, or limited liability companies) or stow them in offshore trusts or corporations.[3] The fact that a debtor seeks to hide assets is nearly *de rigueur,*[4] and of course Ferdinand Marcos famously stashed millions of dollars of Philippine property in Swiss bank accounts.[5] The temptation to hide assets is nearly irresistible in light of the growing legion of attorneys, accountants and business planners who publish books and provide business solutions and schemes to hide and conceal assets.[6] Respectable trade magazines routinely publish ads for "asset protection," whose websites provide elaborate schemes that retitle the property but still repose in the name of the judgment debtor control and access to the property, which in most cases is typically bank and securities accounts, and real property.[7]

Information revealing the debtor's assets is the key to reaching those assets. A sheriff or court on its own will not compel a debtor to disclose known or hidden assets,[8] and recent changes in privacy laws make the discovery of assets more difficult, but not necessarily impossible.

This article is the judgment creditor's roadmap to recompense. This article focuses on, in particular, the California state court remedies[9] available to a judgment creditor to ferret out information that will reveal the assets of a judgment debtor and thereby enable the judgment creditor to reach those assets in the process of satisfying the judgment, but many of the concepts discussed here are, of course, applicable across the country.[10]

HOW TO FIND THE INFORMATION

Absent severe limitations, a judgment creditor is not entitled to the benefit of pre-judgment discovery, such as depositions in the offices of an attorney.[11] The remedies available to a judgment creditor consist of:

(1) an examination of the debtor;

(2) an examination of a third party indebted to the debtor;

(3) the subpoena of persons and records at a hearing on the examination of the debtor;

(4) the production of documents,[12]

(5) interrogatories,[13] and

(6) discovery in a proceeding to determine title to property.[14]

Although these remedies are not as encompassing as pre-judgment discovery, nevertheless the judgment creditor can extract sufficient information that might start the process of reaching assets. The key however is fashioning the right remedy.

Post-judgment, the seminal act of discovery is the appearance and examination of the debtor in open court[15] under state law; in California, that is pursuant to Section 708.110(a)[16] and 708.120(a).[17] Once the defendant appears, or third parties appear, the court has plenary jurisdiction and can order, at the conclusion of the hearing, a turnover order or a restraining order, or even can conduct a trial as to the title to the property.[18] The judge can order the judgment debtor to hand over property to the sheriff, clerk, or court ordered receiver, or, if cash, to the judgment creditors.[19] The court can impound certain assets.[20] The question is: What assets?[21]

Section 708.130[22] imbues in the judgment creditor the power of subpoena to compel the debtor, or related other parties, to produce books, letters, papers, and files at the hearing. A subpoena can be served upon the judgment debtor, or related third party, who might resist or bring inadequate and incomplete records, which is unfortunately routine, and which leads to subsequent hearings that might or might not produce the desired records. Independent third parties, however, might have possession of the debtor's financial records and, with the power of subpoena, the judgment creditor can compel the third parties to appear with records in hand at the debtor's or a third party's post-judgment examination hearing.[23] This is called "tent pole jurisdiction."

The order compelling the debtor or third party to appear invokes the court's jurisdiction to conduct a hearing in which the debtor or third party will appear, and the judgment creditor can conduct an examination, seek

a turnover order or restraining order, or even conduct a trial. What is important is that the court now has the jurisdiction to issue orders, or adjudicate the rights of the parties and non-parties, and in which the judgment creditor can marshal evidence consisting of information from the third party through the power of a civil trial subpoena for records and an appearance.[24] The judgment creditor offers evidence adduced from third person, such as a bank in possession of a financial statement, in setting aside a fraudulent conveyance, or procuring a restraining or turnover order,[25] or obtaining conclusive relief determining the interest in property.[26]

The order compelling the appearance of the debtor or third party is the "tent pole," holding up the tent of post-judgment plenary jurisdiction and authorizing the use of a subpoena to produce evidence at the hearings for expansive post-judgment relief.

THIS INFORMATION WILL TOPPLE ASSET PROTECTION STRATEGIES

Fraudulent conveyances create receptacles to hold the debtor's assets.[27] Third party disclosures[28] reveal the debtor in fact owns property to which a limited liability company, limited partnership, trust, corporation, offshore entity, or family member putatively claims title ownership. In extending credit, financial institutions more often lend to a customer who claims a substantial net worth and typically peg their rates of interest predicated upon the degree of risk. A borrower with a high net worth would be less likely to default and from the bank's perspective the borrower represents a better credit risk and thus it would charge such a borrower a lower interest rate. Seeking to induce the bank to make the loan, and lower the costs of the loan, the borrower readily discloses assets and "pierces" his or her own corporate veil in advising the banks that the borrower actually owns the assets, even though legal title is in the name of a limited liability company, trust, corporation, or partnership.[29] If the borrower represents to the bank that, notwithstanding the fact that a property is titled in the name of the limited liability company, the borrower is the actual owner, the creditor of the borrower could file suit and seek a resulting trust for the property on the basis that the limited liability company is holding the

property for the benefit of the debtor.[30]

Fraudulent conveyances are transformative. Fraudulent conveyances typically transform title to an asset by substituting out the judgment debtor as the technical title holder to an asset and substituting in another entity, such as a family member, trust, corporation, limited liability company, or the like.[31] The debtor still retains the beneficial interest, access, and control over the assets by indirect means.[32] The classic fraudulent conveyance is to close out the debtor's bank account by having the bank issue a cashier's check, payable to the order of the debtor. The debtor endorses the check and deposits the check in the account of an adult child, a Nevada Limited Liability Company or corporation, or an "onshore trust." The debtor is a signatory as an officer of the entity, or readily forges the name of the family member who is indifferent to the disposition of the funds. In responding to inquiries at a debtor's examination, the debtor denies ownership or an interest in the bank account. However, upon completing a financial statement as part of a presentation to a financial institution, the debtor discloses the bank account in question. Transferring homes, or other real estate, to a Limited Liability Company, a limited partnership, "on-shore trusts," or offshore trusts, in which the officers or agents of these entities are the debtor's children, surrogate, or nominee, is a fraudulent conveyance paradigm. A business (or part thereof) transferred from corporation "A" to corporation "B" is a common asset protection scheme.

Fraudulent conveyances propagate claims by the debtor that property is over encumbered, owned in part or whole by others, has been sold to an alleged bona fide purchaser, or has been transferred to a spouse in a marital dissolution. Asset protection manuals always counsel the debtor to refrain from recording lien or judgment releases because the appearance of liens or judgments (even if paid) dissuades competing creditors from enforcing their claims based on the belief that the judgment debtor lacks sufficient equity in the property to justify enforcement.[33] Disclosure made to financial institutions, or third parties,[34] provides information contrary to the claims of the debtor. For example, the debtor claims that the property secures a family debt when in fact disclosures made to the bank or leasing company, disclosures in a bankruptcy, dissolution of marriage, or a commercial credit application omit any family debt. The debtor claims

that the spouse has a separate property, joint tenancy in common interest in the assets, which would reduce, if not eliminate, the debtor's interest. In fact, disclosures to third parties reveal that the debtor is the sole title holder of the asset,[35] or omit the claimed interest of the third party. The debtor denies ownership of property, such as a home and claims that an offshore trust or non-profit corporation is the true owner. Disclosures to third parties contradict these claims when, for example, the debtor is directly paying debt service to a secured creditor, property taxes due the county, insurance, and maintenance, and lists the property as an asset on a balance sheet.

WHERE TO FIND THE INFORMATION

Who has valuable information that would reveal the assets of the judgment debtor and where can one find these parties? This information enables the judgment creditor to prevail in a third party claim, which is the battle between the judgment creditor and a third party over specific assets over which discovery is prohibited.[36] This information assists the creditor in defending against a motion to expunge a lis pendens, in which the creditor shoulders the affirmative burden of proof by a probability.[37] This information identifies assets that are readily subject to enforcement, whether by direct seizure, garnishment, or turnover through supplemental proceedings. Assets such as a patent, copyright, trademark, trade dress, or domain name would prompt the judgment creditor to seek the appointment of a receiver to reach these intangibles.[38]

Once these entities have been identified, the judgment creditor can serve a subpoena duces tecum for appearance at the OEX hearing and production of records:[39]

A. Source: Banks, financial institutions, hard money lenders, private lenders.

1. **Found Where**: Deeds of Trust or encumbrances on real property.[40]
2. **Found How**: Title report, litigation guaranty, property profile, online search, personal inspection of real property records at recorder.

3. **Information**: Uniform residential loan application ("URLA"), three years of tax returns,[41] statements revealing marital status and whether property is separate or community, financial statements, profit and loss statements, lists and descriptions of assets, confirmation of assets and income, marital status, statements of financial worth, statement under Probate Code Section 18100.5.[42] The key item is the URLA, which provides a mini-financial statement and listing of assets and liabilities. The other important items are a preliminary change of ownership report ("PCOR"), which the debtor files with the county tax assessor to disclose whether the transfer is to a related party and no increase in real property taxes can be assessed or whether it is transferred irrevocably to a separate "stand alone" party, which enables the tax assessor to re-assess the property to current values. Most debtors perceive this risk and instead will encumber the real property with a deed of trust to a family member, closely held corporation controlled by the debtor, or limited liability company or limited partnership, similarly controlled by the debtor. Some debtors produce unrecorded quit claims or grant deed or deeds of trust, which might trump an abstract of judgment.[43] The weakness in these transactions goes back to the financial statements provided the bank, which the debtor did not disclose on the URLA, or to the bank's financial statement, where there was no disclosure of the fact of the insider debt, the amount of the debt, or that the debt was secured or to be secured. Asset protection strategies dissuade creditors from enforcement and spawn a campaign to convince the creditor that the asset lacks equity and enforcement is not justified.[44] Leveraging the maximum loan from a financial institution compels the contrary campaign to convince the lender that the debtor has substantial net equities, and the loan is justified.

B. Source: Banks, financial institutions, hard money lenders, vendors, leasing companies, factors, investments funds, syndicates for lenders.

1. **Found Where**: Search through the secretary of state (UCC).[45]
2. **Found How**: Secretary of state directly, or Westlaw, LexisNexis, and

other major legal search service provide this information as part of their "people finder" package.[46] Commercial services provide this information at a very nominal charge.

3. **Information**: This package of information is similar to what the banks might receive from the debtor in a real estate transaction, but with a greater emphasis on financial statements (audited or otherwise), statements and lists of assets, corporation resolutions and articles, and other documents submitted to secure a five to 10 year loan or lease. The key item is the financial statement, which might conflict with the putative financial information provided by the debtor post-judgment or the claim that the debtor no longer owns the asset, but that a successor other entity owns the asset. Leasing companies, factors, vendors, and industrial banks extending commercial credit receive voluminous financial records from the debtor (or accountant), which are accompanied by certifications of authenticity by the debtor's principals.

C. Source: Credit and electronic reports from Dunn & Bradstreet, Experian Information Solutions, Equifax Credit Information Services and TransUnion, Westlaw (Peoplemap), LexisNexis (comprehensive person search) and many others.[47]

1. **Found Where**: The client might have lawfully obtained a credit report, online data compilation services and commercial reports from the major credit reporting agencies, which are available for a fee. These reports reveal other vendors, creditors, financial institutions, and other parties that have extended credit to the debtor. This information might well overlap the information from the recorder's office, or the secretary of state, but occasionally these reports might report a different set of "creditors," given change of names, locale, or identity. These services provide commercial credit reports. Westlaw and LexisNexis have inexpensive and comprehensive search and public records services.
2. **Found How**: Other than a credit report, the major commercial credit reporting agencies all have online presences. Cost of reports range between $50 to $1,000. Westlaw, LexisNexis (Accurint), Lois Law, IRB, and countless online services provide public records searches that provide an entire potpourri of information.

3. **Information**: These services will list recorded and filed public record documents, such conveyances, deeds of trust, abstracts, tax liens, judgments, other involuntary liens, UCC filings, lawsuits, fictitious business filings, limited liability company and corporations in which the debtor is listed as a member or officer,[48] information disclosing neighbors, and local demographics. These services provide partial (or complete) Social Security numbers, phone numbers and other personal information. These providers offer these services through subscription or a one time use (call the provider). If engaging a private investigator,[49] most clients pay large fees ($1,000 for a 10 page single spaced report) for the investigator to perform a $20 electronic search. For example, these services might reveal a lately recorded deed from the debtor to an irrevocable trust, which is the quintessential fraudulent conveyance. Title companies will provide the recorded document, which shows no transfer tax, which suggests that the conveyee did not pay anything of value.[50]

D. *Source: Other suits (federal and state) and litigation pending (or completed) in the courts.*

1. **Found Where**: The U.S. courts are accessible through PACER. Most state courts have an online presence reveals parties, attorneys and "line items" for each filing and some, such as Alameda and San Francisco, provide full or partial access to selected filings. Westlaw has "name search" function for cases throughout the U.S.[51] Court records reveal other actions in which those parties might have significant financial information, sworn statements, affirmations of ownership of an asset or business, or failing to reveal title of the assets in the name of a closely related third party. Any suit filed by the debtor is an enormous wealth of information in disclosing or confirming ownership of the business, representation of the business organization, identity of officers, and directors, the continuity of the business, whether the debtor (or conveyee) is the owner and operator, and representations of management and control. Court records identify disgruntled employees who might disclose information revealing the debtor's financial structure. Dis-

covery, declarations, pleadings, trial testimony, and statements from counsel reveal ownership of property, whether the property is free and clear or encumbered, the financial condition of the debtor, or the putative ownership interest (or lack) of third parties.[52]

2. **Found How**: Online searches and this information is also available from searches undertaken by Westlaw, LexisNexis, and other providers. Search services identify other cases as the judgment creditor faces obstacles searching every county in the state of California, much less out of state.
3. **Information**: The battle ground is identifying assets, which the debtor might have disclosed to other creditors, banks, leasing companies, and factors, which have commenced their own legal proceedings to enforce their debt. This information would reveal assets, and confirm (or deny) the debtor's ownership of assets, which would aid the creditor to prevail in a fraudulent conveyance action, fend off a third party claim, or defeat a motion to expunge. Other cases could evidence the debtor asserting claims of ownership of disputed property (suits against insurance companies, partners, or debtors), identify the correct name of the debtor (suit by debtor as plaintiff, or allegations of other creditors), or show management control ("Declarant is the president of, and manages the affairs of….")

D. *Source: Family law, bankruptcy courts or any other specialized court, agency or tribunal.*[53]

1. **Found Where**: The courts, agency or tribunal, which are typically online.
2. **Found How**: Online or through a professional search firm.
3. **Information**: Divorce requires, absent a sealing order, or waiver, a complete disclosure of assets and liabilities, which is the sure roadmap to recovery. These statements are signed by the debtor under oath and provide great detail in identifying community and separate assets, outstanding debt owed to others including claim insiders, liens, and other claims. If the creditor is proceeding with a levy on real or

personal property and confronts a suspicious lien held by an insider claiming a debt owed by the debtor in the millions, the family law file might not reveal that obligation, or indicate that the debt is unsecured, which information could be used to impeach this competing putative creditor.[54] This information has great value because the statements are made under oath, and support judicial estoppel applications in ancillary fraudulent conveyance litigation.[55]

Bankruptcy court is a source of information if the debtor previously filed for bankruptcy relief; the debtor would have had to file detailed and revealing schedules and statement of affairs, along with period reports (monthly operating reports). If the debtor files a creditor's claim or participates in any bankruptcy lawsuit, the creditor could confirm ownership of the business or asset. Similarly filings in bankruptcy court are under oath, support collateral estoppel applications in state court, and reveal ownership of assets imbued in the name of the debtor.

The United States Copyright Office and United States Patent and Trademark Office are online and have very extensive search options. Ownership of the copyright, trademark, trade dress, or patent suggests that the debtor might own the underlying business.

E. *Source: The commercial landlord.*

1. **Found Where**: Real property records would reveal the owner of the building in which the debtor is a tenant.
2. **Found How**: Title companies for no or a nominal fee will provide "vesting information," or a "property profile," which would identify the landlord.
3. **Information**: Many commercial landlords demand extensive financial information, such as financial statements, tax returns, a list of assets, and organizational information from the debtor.

INFORMATION IS POWER[56]

With information in hand and potentially online, counsel for the judgment creditor can collect the judgment for the client. This article serves as

a roadmap to sources of information that would provide the treasure map, consisting of the URLA, the PCOR, and financial statements that reveal the debtor's assets.

All you have to do is look.

NOTES

[1] Typically, victims of major tort, fraud, and financial collapse lack any information, while commercial creditors, financial institutions, and spouses have some information.

[2] Money judgments are not self-executing, and a judgment creditor must enforce the judgment under the California Enforcement of Judgment law. CCP Section 683.020 seq. The post-judgment battleground is reaching assets that have been hidden, secreted, or fraudulently conveyed; that fact is well known to the asset protection industry, which offers an entire array of schemes to shield, hide, and secret assets.

[3] *See* Uniform Fraudulent Transfer Act, CCP Sections 3439 seq.

[4] This author has engaged in the enforcement of debts and judgments for 36 years, and marvels when a bank levy actually reaches funds on hand.

[5] *See e.g., In re Estate of Marcos Human Rights Litigation*, 910 F. Supp. 1470, at 1470 (D. Ct. Hawaii, 1995): "The evidence at trial demonstrated that the Estate had approximately $320 million deposited in Swiss bank accounts in Switzerland. In her answer to Plaintiff's Interrogatory No. 4, Imelda R. Marcos was asked to identify, "each asset belonging to Ferdinand Marcos as of his date of death (whether real property, personal property, or property beneficially or equitably owned or owned in conjunction with others)...." Her response was, ... "... I believe other assets of my late husband may be located in the following banks in Switzerland: Credit Suisse, Banque Paribas (Suisse), Lombard Odier & Cie, Swiss Bank Corporation, Swiss Volksbank, Fianz AG, Trade Development Bank. I believe the approximate amount which may be located in accounts in these banks to be in the range of $300 Million-$320 Million."

[6] Counseling a client to commit a fraudulent conveyance or aiding and abetting is a state bar disciplinary offense. *In Re Townsend*, 32 Cal. 2nd 592, 593 (1948).

[7] Foreign states compete as offshore havens: Belize, Antigua, the Bahamas, Cayman Islands, Bermuda, Switzerland, Luxemburg, the Cook Islands,

Isle of Wight, Jersey Islands, Costa Rica, and Panama, among innumerable others. These foreign states offer powerful secrecy laws making penetration of offshore trusts and corporations, discovery of financial records, or any legal proceeding very difficult and expensive.

[8] The most fundamental remedies are recording an abstract with the county recorder, filing a lien with the secretary of state and service of an order of examination, all of which encumber the debtor's real and personal property. *See* California Code of Civil Procedures Sections 697.540, 697.530, 708.110(d), and 708.120(c)

[9] If the judgment is entered in federal court, the judgment creditor can employ state court post-judgment remedies, or discovery under the Federal Rules of Civil Procedure, but not both. Fed. R. Civ. Pro. 69(a)(2).

[10] Unpublished authority has rejected use of a subpoena duces tecum (deposition subpoena), *see Mancinelli v. Siewak* 2009 WL 924285 (Cal App. 4 Dist 2009). In federal court, the judgment creditor can exercise all rights of civil discovery, rendering this state court case irrelevant. In seeking to domesticate an out of state judgment, foreign judgment, judgment from another district court, local, out of state or foreign arbitration award, the creditor should carefully gauge the difficulty of enforcement. State courts provides daily law and motion calendars, judges who have great familiarity with post-judgment remedies, and routinely deal with creditor/debtor matters, as opposed to federal judges who rarely preside over routine enforcement matters. In a state court enforcement proceeding, the judgment creditor can employ the sheriff, who can readily and routinely seize and sell virtually any personal property and sells real property on a monthly basis. Many U.S. marshals balk at routine civil post-judgment and suggest that the local constable, state court marshal, or sheriff enforce the judgment. However, if discovery is the battleground, the litigant might fare better in federal, than state, court. The inability to readily enforce a default through a levying officer indirectly immunizes the judgment debtor's assets because the judgment creditor cannot reach those assets through routine process.

[11] Federal discovery remedies better assist the judgment creditor if the debtor is out of state or is difficult to serve with post-judgment process and allows the judgment creditor to conduct a deposition, engage in broad discovery through subpoenas, and easily redress in the event of a discovery dispute through the magistrate judge under Fed R. Civ. Pro. 26-37.

[12] CCP Section 708.030.

[13] CCP Section 708.020.

[14] *See* CCP 708.180(a): "(a) Subject to subdivision (b), if a third person examined pursuant to Section 708.120 claims an interest in the property adverse to the judgment debtor or denies the debt, the court may, if the judgment creditor so requests, determine the interests in the property or the existence of the debt. The determination is conclusive as to the parties to the proceeding and the third person, but an appeal may be taken from the determination. The court may grant a continuance for a reasonable time for *discovery proceedings,* the production of evidence, or other preparation for the hearing." (emphasis added)

[15] A debtor's examination is a public proceeding. *Nebel v. Sulak* 73 Cal. App. 4th 1363, 1366 (Cal. App. 2 Dist. 1999). A debtor's examination compels both the appearance of the debtor and the testimony from the debtor, and witnesses compelled to appear through a subpoena.

[16] CCP Section 708.110(a) provides as follows: "The judgment creditor may apply to the proper court for an order requiring the judgment debtor to appear before the court, or before a referee appointed by the court, at a time and place specified in the order, to furnish information to aid in enforcement of the money judgment." At the examination, the judgment creditor has the opportunity to inquire of the judgment debtor regarding property the debtor has, or may acquire in the future, that may be available to satisfy the judgment. A judgment debtor examination is intended to allow the judgment creditor a wide scope of inquiry concerning property and business affairs of the judgment debtor. *Hooser v. Superior Court* 84 Cal. App. 4th 997, 1002 (Cal. App. 4 Dist. 2000).

[17] CCP Section 708.120(a): "Upon ex parte application by a judgment creditor who has a money judgment and proof by the judgment creditor by affidavit or otherwise to the satisfaction of the proper court that a third person has possession or control of property in which the judgment debtor has an interest or is indebted to the judgment debtor in an amount exceeding two hundred fifty dollars ($250), the court shall make an order directing the third person to appear before the court, or before a referee appointed by the court, at a time and place specified in the order, to answer concerning such property or debt."

[18] CCP Section 708.180(a): "Subject to subdivision (b), if a third person examined pursuant to Section 708.120 claims an interest in the property adverse to the judgment debtor or denies the debt, the court may, if the judgment creditor so requests, determine the interests in the property or the

existence of the debt. The determination is conclusive as to the parties to the proceeding and the third person, but an appeal may be taken from the determination. The court may grant a continuance for a reasonable time for discovery proceedings, the production of evidence, or other preparation for the hearing."

[19] CCP Section 708.205(a): "Except as provided in subdivision (b), at the conclusion of a proceeding pursuant to this article, the court may order the judgment debtor's interest in the property in the possession or under the control of the judgment debtor or the third person or a debt owed by the third person to the judgment debtor to be applied toward the satisfaction of the money judgment if the property is not exempt from enforcement of a money judgment. Such an order creates a lien on the property or debt."

[20] CCP 708.205(b): "If a third person examined pursuant to Section 708.120 claims an interest in the property adverse to the judgment debtor or denies the debt and the court does not determine the matter as provided in subdivision (a) of Section 708.180, the court may not order the property or debt to be applied toward the satisfaction of the money judgment but may make an order pursuant to subdivision (c) or (d) of Section 708.180 forbidding transfer or payment to the extent authorized by that section."

[21] Typical testimony at a debtor's examination: "Do you have a bank account?" "Currently?" "Yes." "Not sure." "Do you sign on any bank account?" "Sign what?" "Your name?" "Where?" "On the check?" "Where?" "On the lower right hand side." "Not sure." "Do you have access to any funds from a bank account?" "Not sure what you mean by access?" "Access means that you can get money." "Money?" "Yes." "Checks aren't money. Checks are paper. Didn't you know that?" "Did you bring the records which I described in the subpoena served upon you?" "No." "Why not?" "Don't have any." "Why not?" "Never had any in the first place." "Why?" "Never my account." "What is so difficult to understand here?"

[22] CCP Section 708.130: "(a) Witnesses may be required to appear and testify before the court or referee in an examination proceeding under this article in the same manner as upon the trial of an issue. (b) The privilege prescribed by Article 4 (commencing with Section 970) of Chapter 4 of Division 8 of the Evidence Code does not apply in an examination proceeding under this article."

[23] This topic is a near stranger to the appellate bench but important. In an unpublished opinion, *Mancinelli v. Siewak* 2009 WL 924285, at p. *4 , n. 6

(Cal App. 4 Dist 2009) the court authorized service upon witnesses holding documents, if part of a debtor's examination under Section 708.110(a) as follows:

> "Indeed, *MacAdam* seems to contain the seeds of an approach that would permit Mancinelli to obtain some of the materials sought by his subpoenas: pursuit of judgment debtor's examination under Section 708.110, with witness subpoena's under Section 708.130 to entities with documents relevant to the issues that will arise in the judgment's debtor's examination. However, Mancinelli did not elect to pursue that procedure, and we express no opinion on the extent to which that procedure might yield the documents encompassed by Mancinelli's business records subpoenas issued here." In accord: "Enforcing Judgments and Debts," Alan Ahart, Rutter Group, 2009, Par. 6:1282 (any person with knowledge leading to enforcement ("e.g., debtor's bookkeeper, accountant or non debtor spouse") can be subpoenaed as trial witness at OEX); *see also* Section 6:1301 (more effective examination if records are subpoenaed from non party custodians, e.g., a bank, attorney, accountant, title company brokerage firm or employer.) Alan Ahart is a sitting bankruptcy judge, United States Bankruptcy, Central District of California.

[24] Typical testimony at a third party claim proceeding. "Are you the loan officer?" "Yes." "Did the defendant hand you these records?" "Yes." "Did he disclose to you that the business was not owned by him but by a limited liability company managed by his spouse?" "No." "Did the defendant tell you that he transferred the business to an entity controlled by this wife?" "No." "Did you have any reason to believe that the business operated by (or asset owned by) was in the name of someone other than the debtor?" "No." "How did he describe the business?" "As his." "Thank you, no further questions." Third party claims can be trials. *Cassel v. Kolb* 72 Cal.App.4th 568 (Cal. App.1 Dist. 1999).

[25] At the conclusion of the hearing, the judgment creditor can seek a turnover order. S*ee, e.g.*, *Imperial Bank v. Pim Electric* 33 Cal. App. 4th 540, 545 (Cal App. 1 Dist. 1995) ("Under section 708.120, subdivision (a), the court or referee may order the person examined, be it the judgment debtor or a third person, to deliver property or funds to a levying officer or directly to the judgment creditor. [citation omitted] The court or referee may also appoint a receiver and may order the judgment debtor to make "necessary assignments or deliveries to the receiver for the purpose of sale or collection." (Comment

to § 708.205, *supra*.) Moreover, the court or referee may order that execution be issued to collect the sum due. (*Ibid.*) Property that is to be sold under section 708.205, subdivision (a), will be sold by a levying officer, provided a writ of execution is outstanding, or by a court-appointed receiver. (Comment to § 708.205, *supra.*)") An OEX hearing leads to orders that are final and subject to direct appeal as is virtually all post-judgment relief.

[26] Section 708.180 authorizes the trial court to decide whether the third party has made a good faith claim to the interest in property adverse to the judgment debtor, or good faith denial of a debt due the judgment debtor, and absent good faith, the court may determine the interest in the property, or the existence of the debt. These determinations are conclusive as to the parties and third parties. These proceedings are trials that produce judgments reviewable by appeal. *See Evans v. Paye* 32 Cal. App. 4th 265 , 276-278 (Cal. App. 3 Dist. 1995).

[27] *See* "Transcript of Proceedings Judge's Ruling, *In re: Jimmy Jen; Wirum v. Jen*," U.S. Bankruptcy Court, Northern District of California, December 14, 2007, Docket #29, entered on January 1, 2008 for a detailed discussion of fraudulent conveyances (pages 8-18); *see also In re Stephen B. Turner; Kendall v. Turner,* 335 B.R. 140 (Bankr. N.D. Cal., 2005); *see also In re Stephen B. Turner; Kendall v. Turner* 345 B.R. 674 (Bankr. N.D., Cal. 2006); *see also In re Stephen B. Turner; Kendall v. Turner,* 2007 WL 723117 (9th Circuit, BAP (Cal.)) (cases illustrate fraudulent conveyances).

[28] For purpose of brevity "third party disclosures" mean information provided by the debtor to a third party.

[29] The customer tells the bank that the limited liability company holds title for "tax" or "liability reasons." Warehousing commercial, industrial, or large scale residential (apartments) in a limited liability company is common, where the entity provides limited protection against the owner for many contract and limited tort claims.

[30] The creditor can assert a resulting trust and file suit to have the property declared to constitute an asset of the judgment debtor and applied on account of the judgment. *See* directly on point *First Fidelity etc. v. Schroeder,* 179 Cal. App. 4th 834 (Cal. App. 5th Dist. 2009). A resulting trust is a remedy associated with the remedies available under the Uniform Fraudulent Transfer Act and the Uniform Fraudulent Conveyance Act. The resulting trust remedies reach properties warehoused in limited liability companies, particularly real estate.

[31] A fraudulent conveyance is any act to hinder, delay or defraud the creditor

including converting a stock account or checks into cash. *See In re Bernard,* 96 F. 3d 1279 (9th Cir. 1996) (converting stock accounts and checks into cash is a fraudulent conveyance because the transformation makes the asset more difficult to reach by a judgment creditor, even though the judgment debtor retained possession of the funds).

[32] "The Death of Liability," Lynn M. LoPucki, Yale *Law Review*, October, 1995, Vol. 106, p. 1, is the seminal law review in this area. *See also* "Developing the Asset Protection Dynamic: A Legacy of Federal Concern," John K. Eason, Hofstra Law Review, Vol. 31 (Feb. 2004), pp 23-89. The legal bibliography now overflows with well written articles, and constraints of space preclude an entire listing. Despite the mundane flaw of asset protection, this topic arouses the passions of the most staid. Successful asset protection enables the wrongdoers to terrorize the innocent and destroy the social fabric without the fear of any financial or personal consequences. Asset protection is now a visitor to the Supreme Court as follows:

"Chancery may have refused to issue injunctions of this sort simply because they were not needed to secure a just result in an age of slow-moving capital and comparatively immobile wealth. By turning away cases that the law courts could deal with adequately, the Chancellor acted to reduce the tension inevitable when justice was divided between two discrete systems. See Wasserman, *supra,* at 319. But as the facts of this case so plainly show, for creditors situated as Alliance is, the remedy at law is worthless absent the provisional relief in equity's arsenal. Moreover, increasingly sophisticated foreign-haven judgment proofing strategies, coupled with technology that permits the nearly instantaneous transfer of assets abroad, suggests that defendants may succeed in avoiding meritorious claims in ways unimaginable before the merger of law and equity. *See* LoPucki, The Death of Liability, 106 Yale L. J. 1, 32-38 (1996). I am not ready to say a responsible Chancellor today would deny Alliance relief on the ground that prior case law is unsupportive." (Dissent of Justice Ginsburg, *Grupo Mexicano de Desarrollo, S. A. v. Alliance Bond Fund, Inc*., 527 U.S. 308, 338-39 (1999) [Justice Ginsburg penned this dissent in 1999, upon the rise of the Internet and the cusp of Internet banking. Had Justice Ginsburg written this dissent in 2010-2011, she might have expressed her concern that the judgment debtor might have whisked away millions through bank transfers facilitated through an iPhone (or iPad) in the courthouse elevator.)].

[33] This author had first hand experience. In contemplating the enforcement

of a $500,000 judgment, the author noted a $1,000,000 senior lien due a local financial institution represented by counsel. The author contacted counsel to inquire if the debt had been paid. Counsel stated the following: "You just made $500,000.00. The bank debt has been paid full, and debtor never recorded the lien release. Congratulations."

[34] In other civil litigation, the debtor might disclose financial, title, or ownership information in routine discovery, such as depositions, answers to interrogatories, document production, and deposition from third parties. In seeking to confirm ownership of a cattle ranch in which the defendant disputed ownership, the author purchased from another litigant the debtor's deposition, in which he admitted ownership. The case settled upon receipt of the deposition transcript. In litigation brought by a concrete supplier, the contractor denied delivery of the concrete to the job sites. The supplier pulled the city permits. The case settled in 30 minutes at the settlement conference.

[35] More likely, that the property is held as community property and subject to enforcement in the entirety. California Code of Civil Procedure Section 695.020(a) (community is subject to enforcement for the debtor of any member).

[36] *See Whitehouse v. Six Corporation* 40 Cal. App. 4th 527 (Cal. App. 2 Dist. 1995) (summary proceeding, no right of discovery, no jury trial, no findings, and direct right of appeal. Given the lack of findings and the summary nature, the loser in any third party proceedings would face enormous difficulties in presenting a sufficient detailed factual records to support an appellate issue.).

[37] CCP Section 405.32 ("In proceedings under this chapter, the court shall order that the notice be expunged if the court finds that the claimant has not established by a preponderance of the evidence the probable validity of the real property claim.").

[38] General intangibles, such as patents, copyrights, trademarks, trade dress, and domain names, are reached by way of a post-judgment receiver. *See Ager v. Murray* 105 US 126 (1881).

[39] Compliance with CCP Section 1985.3 might be necessary. Expect a motion to quash. *Hooser v. Superior Court* 84 Cal. App. 4th 997, 1002-1003 (Cal. App 4 Dist 2000). Judgment debtor entitled to assert same privileges that a trial witness may assert for refusing to answer questions or respond to request for information. Same: *Brannon v. Ghafouri* 2002 WL 1067799, at 2 (Cal. App. 2 Dist 2002).

[40] If the debtor has recently sold property, the judgment creditor should

subpoena the escrow company to identify the disposition of any funds.
[41] Tax returns might retain their protected status and not be subject to production through post-judgment discovery. *See Brannon v. Ghafouri* 2002 WL 1067799, at 3 (Cal. App. 2 Dist 2002). While the lack of tax returns might hobble judgment creditors, a completed URLA would provide substantial information. The judgment creditor might achieve a different result in federal court.
[42] Debtors frequently transfer assets to an alleged irrevocable trust which would compel the judgment creditor to levy on the assets and face a third party claim, or file a fraudulent conveyance action and record a list pendens. Whether a third party claim, or fraudulent conveyance action, the conveyee will assiduously defend his or her position. In a third party claim the conveyee's defense is the claim of valid title, in which the creditor is deprived of pre-trial discovery. In a motion to expunge filed by the conveyee, the creditors might not have had sufficient time to proceed with discovery because these motions are filed for tactical reasons at the outset of the case when plaintiff is still developing the case. Whether litigating a third party claim, or defending against a motion to expunge, the creditor shoulders the burden of proof by a preponderance of the evidence that the debtor committed a fraudulent conveyance. *Whitehouse v. Six Corp*., 40 Cal.App.4th 527 at 534 (Cal.App.2 Dist. 1995). Whether the alleged trust is revocable or irrevocable is determined, in part, through a statement under Probate Code Section 18100.5 (a) as follows:

> (a) The trustee may present a certification of trust to any person in lieu of providing a copy of the trust instrument to establish the existence or terms of the trust. A certification of trust may be executed by the trustee voluntarily or at the request of the person with whom the trustee is dealing.
> (b) The certification of trust may confirm the following facts or contain the following information:… (4) *The revocability or irrevocability of the trust and the identity of any person holding any power to revoke the trust.”* (emphasis added)

[43] Unrecorded instruments take priority over recorded abstract of judgment (*Bank of Ukiah v. Petaluma S. Bank* (1893) 100 Cal. 590 [35 P. 170]; *Wells Fargo Bank v. PAL Investments, Inc.* (1979) 96 Cal.App.3d 431 [157 Cal. Rptr. 818]; *Boye v. Boerner* (1940) 38 Cal.App.2d 567, 570 [101 P.2d 757]). This applies to the recordation of an abstract of judgment (*Livingston v. Rice* (1955) 131 Cal.App.2d 1, 2-3 [280 P.2d 52]). [This author confronts exactly

these facts many times. In a million dollar adulterated food case, the debtor in the face of an adverse statement of decision recorded two pre-dated deeds of trust. When confronted at the deposition why the deeds of trust were not recorded years before, the answer was "I left it in the drawer." In a substantial commercial rent case, the debtor recorded about six pre-dated grant deeds in favor of a wholly controlled LLC and family members. Another "left in the drawer.").

[44] "Get rid of those pesky creditors."

[45] Financing statements are filed in the domicile for the debtor corporation, such as Delaware.

[46] *See, e.g.,* Lexis: subscription service or a la carte pricing http://law.lexisnexis.com/webcenters/lexisone; Acurrint (owned by LexisNexis, same database) a la cart pricing at http://www.accurint.com/price2.html; D & B report: subscription or $149 or as priced; Experian, Transunion, Equifax – subscription only (these services sell products at various prices). This list is illustrative only, and private investigator or other online search services provide different or more extensive information.

[47] This is not a comprehensive list but only illustrative.

[48] The fact that the debtor is a member of a newly formed limited liability company or corporation suggests that these new entities serve as a receptacle for the debtor's property, particularly if the member is the debtor's wife, using her maiden name. Asking for a maiden name (or other names) of a spouse is paramount in unwinding asset protection schemes as the use of a maiden (or other name) authorizes the spouse to establish bank accounts in a name that is dissociated from the debtor. In civil discovery, counsel should aggressively pursue discovery of all names, including nicknames, ethnic names, maiden names, middle names and any prior changes of name. Likewise, counsel should pursue whether the defendant carries a passport for another country. Expect a big battle.

[49] Counsel or parties can retain a private investigator that in the first round will pull up commercial reports provided by the major services (West|Law, LexisNexis etc.). Counsel should employ enormous care to avoid paying premium prices for information available at a fraction of the cost, or information obtained illicitly.

[50] Counties and cities charge a transfer tax at the rate of about of 1.5 percent (per $1,000) of the consideration (price) paid for the property. Fraudulent conveyors and conveyees avoid payment of (or claiming to pay) the transfer

tax due to the reassessment required under Proposition 13. On the other hand, parties fabricate a claim of a transfer tax to fool the creditor. No transfer taxes being paid is near prima facie evidence of a fraudulent conveyance, assuming that the property has sufficient equity to create a "leviable interest." *See Mehrtash v. Mehrtash* 93 Cal. App. 4th 75 (2001).

[51] Westlaw and other legal searches provide search functions based on an annual subscription service.

[52] "Mr. Jones, you are suing my client, Mr. Smith, to evict him from your building." "Yes." "Mr. Smith was your tenant." "Yes." "He failed to pay the rent due you, as you claim." "You bet." "Do you recall that Mr. Smith told you that the building was in a state of disrepair." "No. Does not ring a bell." "Well, if the building was in a state of disrepair, you would agree with the statement that it would be your obligation to fix up the building." "Yes." "That's because you own the building." "Yes." "And you own the building without any partners." "Yes." "Free and clear?" "Yes…. Why do you ask?"

[53] Tax courts, administrative tribunals, hearings before planning commissions, city and county counsels, and other city, county and state agencies or departments.

[54] In fending off enforcement the debtor claims that the $150,000 Lamborghini collateralizes a family loan. The financial disclosures in the recent divorce list the car free and clear.

[55] *Jackson v. County of Los Angeles*, 60 Cal.App.4th 171 (Cal.App.2 Dist. 1998) (judicial estoppel).

[56] The Latin phrase *scientia potentia est,* "For also knowledge itself is power," was stated by Sir Francis Bacon; today, it is often paraphrased as "knowledge is power."

Wiretaps and Undercover Sting Operations: Are White Collar Defendants Ready?

MARK B. SHEPPARD AND RYAN ANDERSON

"Out are the days of resting easy in the belief that only self-reporting or tipsters will bring criminality to light. In are the days of proactive and innovative white collar enforcement."

– Lanny Breur, February 25, 2010, at the 24th annual National Institute on White Collar Crime.

The U.S. Department of Justice has aggressively used proactive enforcement techniques such as undercover sting operations and enhanced use of electronic surveillance in white collar cases. The recent Foreign Corrupt Practices Act ("FCPA") arrests at a Las Vegas gun show following a two-year long sting investigation and the *Galleon* case in New York are but two of the more prominent examples. These techniques, once reserved for drug and organized crime conspiracies are now becoming part of garden variety health care and financial fraud investigations. As a result, white collar practitioners can no longer afford to be in the dark regarding these techniques and the law that surrounds them.

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Consider, that, in a recent FCPA sting case, there were 22 defendants, 16 unsealed indictments that "represent the largest single investigation and prosecution against individuals in the history of DOJ's enforcement of the FCPA," according to a DOJ release. The indictments, following over two and a half years of sting operations, allege that the 22 defendants allegedly agreed to pay a 20 percent bribe to sales agents supposedly representing the foreign defense minister in return for a $15 million contract. In reality, the sales agent was an undercover FBI agent.

And consider this, in the *Galleon* case: There were over 18,000 intercepted recordings through use of informant wearing a wire — thousands of wiretaps were made in the criminal investigation between 2003 and 2009. David Slaine, a former hedge fund manager was identified as a government "mole" in an undercover sting operation targeting the fallen Galleon Group. Slaine agreed to secretly record conversations used against Galleon after federal authorities caught him trading on inside tips supplied by UBS in a separate case. On March 10, 2010, it was reported that federal prosecutors wired several cooperating witnesses in the Galleon Group insider trading case in order to obtain information on other targets of the investigation.

The wiretapping law jurisprudence that developed in the 1970s has been well settled for decades and practitioners in drug and gang cases are very familiar with this area of the law. White collar practitioners are now confronted with these old tactics in a new forum. White collar defendants are being caught on tape and their attorneys must be prepared to defend against the tapes. The applicability of the wiretapping laws to white collar cases is new, relatively uncharted and as such, presents both concern and opportunity.[1]

DEFENDING AGAINST TITLE III EVIDENCE — FEDERAL WIRETAP LAW

Congress enacted the Federal Wiretap Act as part of the Omnibus Crime Control and Safe Streets Act of 1968 ("Title III") in an effort to balance the privacy rights of individuals and the legitimate needs of law enforcement.[2] The Act seeks to safeguard privacy in oral and wire communications while simultaneously articulating when law enforcement officials may intercept

such communications.[3] Title III prohibits the intentional interception of wire, oral or electronic communications, unless specifically provided for in the statute.[4]

The strict procedural and evidentiary requirements of the Act, provide plenty of room for creative lawyering. Although courts have been less and less likely to enforce the strict requirements of sealing or having the proper official sign the application, rather than just authorize the wiretap, there is still plenty to fight when confronted with wiretap evidence.

Challenges to a Title III Electronic Interception

Challenge Each Wiretap Application, Supporting Affidavit and Order Independently, On Its Face

A defendant should analyze and challenge each separate application.[5] In addition, when defending the wiretap applications and orders, the government is limited to the information contained only within the application and affidavits as presented to the authorizing court.[6] Note that the government can use testimony or affidavits incorporated by reference in the application (as long as these documents are also presented to the authorizing court).

DOJ Official Authorization

Title III requires that the Attorney General of the Department of Justice or a subordinate designated by the Attorney General authorize an AUSA's wiretap application. The DOJ official authorizing the wiretap application must be specifically identified.[7] The wiretap order must also identify the DOJ official who authorized the application.[8]

The Title III provisions concerning official authorization are as follow:

- Section 2518(10)(a)(iii): Gives authority to challenge wiretap orders;
- Section 2518(4)(d): Requires orders to reflect the identity of the authorizing official;
- Section 2516(1): Provides which DOJ officials are empowered to authorize an application.

There are many cases where the government fails in this step and the result is mixed between suppression of the wiretap and upholding the wiretap.[9]

Sealing

Sealing is another procedural requirement that can be challenged, although the results are again, mixed. Title III states that "[i]mmediately upon the expiration of the period of the order [authorizing wiretapping], or extensions thereof, such recordings shall be made available to the judge issuing such order and sealed under his directions."[10] "The government must follow these procedures or it cannot use the intercepted communications against the surveilled individual in a criminal trial. To use wiretap evidence, the government must (1) seal the tapes immediately or (2) provide a 'satisfactory explanation' for the delay in obtaining a seal."[11]

Therefore, at the beginning of any wiretap litigation it is essential to visit the facility housing the original tapes or data, and examine the sealing orders and logs for the data.

Minimization Challenges

Title III demands minimization of the eavesdropping on calls:

> .... Every order and extension thereof shall contain a provision that the authorization to intercept shall be executed as soon as practicable, shall be conducted in such a way as to minimize the interception of communications not otherwise subject to interception under this chapter, and must terminate upon attainment of the authorized objective, or in any event in thirty days. In the event the intercepted communication is in a code or foreign language, and an expert in that foreign language or code is not reasonably available during the interception period, minimization may be accomplished as soon as practicable after such interception.[12]

The Third Circuit has advised that "[o]ur inquiry is on the 'reasonableness' of minimization efforts, under the totality of the circumstances."[13]

In *Scott*, the court found that such circumstances included "the purpose of the wiretap and the information available to the agents at the time of interception."[14] Thus, minimization requirements are less stringent where, because of coded language and one-time only calls, "agents can hardly be expected to know that calls are not pertinent prior to their termination."[15]

The Third Circuit further instructs that "[t]he mere number of intercepted, but nonpertinent calls, is not dispositive."[16] In *Armocida,* where agents intercepted 77 "personal" calls, most of which lasted less than two minutes, the court stated that under the circumstances it would not find "that a full interception of a one-and-one-half minute to two minute conversation violates the minimization requirements."[17]

The Third Circuit has articulated three "crucial" factors for the minimization analysis.[18] First, a court reviewing minimization efforts should consider "the nature and scope of the criminal enterprise under investigation."[19] "[S]omewhat greater latitude may be allowed where conspirators converse in a colloquial code, thereby creating superficially innocent conversations that are actually relevant to the investigation."[20] Moreover, large-scale investigations of criminal conspiracies may need to intercept a greater number of conversations, especially when "the judicially approved wiretap is designed to identify other participants in the conspiracy and to determine the scope of the conspiracy."[21] More recently, the *Hull* court reiterated that "when investigating a wide-ranging conspiracy between parties known for their penchant for secrecy, broader interceptions may be warranted."[22]

Second, courts should consider "the government's reasonable expectation as to the character of, and the parties to, the conversations."[23] By way of example, "if the government knows during what time of the day the telephone will be used for criminal activity, it can avoid intercepting calls at other times."[24] The Supreme Court in *Scott* explained that while agents should not listen to every call over a wiretap on a public telephone where one person is suspected of placing illegal bets, "if the phone is located in the residence of a person who is thought to be the head of a major drug ring, a contrary conclusion may be indicated."[25]

Third, "the degree of judicial supervision by the authorizing judge" must be considered.[26] Section 2518(6) of Title III "permits a district judge,

once he has authorized a wiretap, to continue supervising the operation of the interception by requiring reports from the government." *Id.* Such supervision should be taken into consideration when determining the adequacy of the government's minimization efforts.[27]

The minimization argument, however, is a tedious one that is of limited benefit. In *United States v. Cox*,[28] the court allowed for the only remedy for failure to minimize wiretapping to be a civil suit for the disclosure of the information under § 2520. In *United States v. LaGorga*,[29] the court decided that suppression only applies to the specific interception which is determined to be unlawful, rather than a blanket order which would affect all the evidence, including that obtained by procedures sanctioned by statute and court order.

"Necessity" Shortcomings as a Challenge to Electronic Interceptions

Necessity and Normal Investigative Techniques

Title III demands that each wiretap application include "a full and complete statement as to whether or not other investigative procedures have been tried and failed or why they reasonably appear to be unlikely to succeed if tried or to be too dangerous."[30]

Similarly, a wiretap order must show the judge's determination that the procedure is necessary: "Upon such application the judge may enter an ex parte order … authorizing … interception of … electronic communications … if the judge determines on the basis of the facts submitted by the applicant that … normal investigative procedures have been tried and have failed or reasonably appear to be unlikely to succeed if tried or to be too dangerous."[31]

"The statutory language suggests that before finding that a wiretap is necessary, the court must find that alternative methods have been tried or would not have succeeded."[32] Electronic interceptions should not be permitted if "traditional investigative techniques would suffice to expose the crime."[33] In order to satisfy this requirement, however, the government need only lay a "factual predicate" sufficient to inform the judge why other methods of investigation are not sufficient.[34]

Although the application for a wiretap is likely to follow the guidance of the courts and reflect that alternative methods have been tried and failed, it is possible through a Franks hearing to show that those methods were exaggerated.[35] After the Franks analysis, it was determined that, given an informant who was willing to testify, the necessity requirement was not met.

Many of the normal investigative techniques that must be exhausted before the government resorts to a wiretap are listed below:

- Search warrants
- Witness interviews
- Grand jury testimony/subpoena
- Cooperating witnesses/informants
- Infiltration by undercover agents
- Surveillance
- Video surveillance
- Trash covers
- Mail covers
- Financial investigations
- Pen registers
- Toll registers (phone records)
- Trap and trace[36]

Specificity and Boilerplate

Circuit courts have rejected the use of boilerplate language in support of a necessity showing. The government, "[M]ust allege specific circumstances that render normal investigative techniques particularly ineffective or the application must be denied...."[37]

The government cannot use the investigating agents' conclusions regarding whether or not traditional investigative techniques will theoretically work or not work. The required necessity cannot be shown by "bare conclusory statements that normal techniques would be unproductive."[38]

Previous Investigations or Applications cannot be Used as the Proof of Necessity

The necessity rule requires that each wiretap application stand on its own. The government cannot aggregate necessity from other wiretap applications to show necessity for a subsequent application.[39]

The need for individualized necessity and probable cause showings often is at issue in extension applications. Extension applications are not merely formalities that automatically extend an original wiretap. Section 2518(5) of Title 18 requires that each application for an extension of a wiretap must include a full statement of facts regarding necessity, as is required for original applications under Section 2518(l)(c). There is, however, an additional statutory requirement in Title III for extension applications. Section 2518(l)(f) specifically requires an extension affidavit to provide "a statement setting forth the results thus far obtained from the interception, or a reasonable explanation of the failure to obtain such results."[40] Failure to provide adequate necessity for an application means that probable cause is not shown and the wiretap will be suppressed.[41]

The Supreme Court has acknowledged these separate requirements for extension applications. In *Giordano*, the Court observed that "extension orders do not stand on the same footing as original authorizations … but are provided for separately."[42] It then emphasized the additional showing required by Section 2518(l)(f).[43] The Court found a common sense rationale for this greater showing: Plainly the function of § 2518(l)(f) is to permit the court realistically to appraise the probability that relevant conversations will be overheard in the future. If during the initial period, no communications of the kind that had been anticipated had been overheard, the Act requires an adequate explanation for the failure before the necessary findings can be made as a predicate to an extension order.[44]

Probable Cause Shortcomings in Wiretap Applications and Orders

The Three Probable Cause Requirements of Title III

A wiretap application (and the resulting order) must establish probable cause in relation to three facts: i) that an individual is committing crime, ii)

that communications about that crime will be intercepted, and iii) that the phone line tapped is being used to communicate about the crime.[45]

As with a traditional search warrant affidavit, a wiretap application must establish that the target has committed or is committing a crime.[46] There are limits as to which crimes are permissible bases for a wiretap (albeit, very broad limits). The statute permits wiretaps for crimes enumerated in 18 U.S.C. § 2516. That statute, in turn, provides a laundry list of federal offenses ranging from assassination of the President to obscenity. The classic wiretapping subjects — drugs and guns clearly fall within the statute, as do all acts of fraud, wire fraud, and bank fraud, as well as computer fraud and nearly one-hundred other enumerated offenses. If the wiretap produces unusual charges, it is worth it to check Section 2516 to make sure the crime is enumerated.

Before obtaining a wiretap, the government must show probable cause that communications about the crime will be intercepted.[47]

The final probable cause requirement is whether the specific target line (a specific phone number) is being used for criminal conversations.[48] This is closely related to the second requirement, that "particular communications" regarding crimes will be intercepted (Section 2518(3)(b)).

Both (b) and (c) appear to be areas ripe for defending in white collar cases. The chances that white collar defendants will be communicating at any particular time about a criminal enterprise, or that a particular line may be fruitful for the investigation would seem hard to prove given the likelihood that any tapped line would be used, in the vast majority of calls, for legitimate business purposes.

Staleness is another area where an argument can be made against the wiretap. Staleness, however, is unlikely to work. The Third Circuit Court of Appeals has explained that "where the facts adduced to support probable cause describe a course or pattern of ongoing and continuous criminality, the passage of time between the occurrence of the facts set forth in the affidavit and the submission of the affidavit itself loses significance."[49] The court has further specified that "[t]he liberal examination given staleness in a protracted criminal conduct case 'is even more defensible in wiretap cases than in ordinary warrant cases, since no tangible objects which can be quickly carried off are sought.'"[50]

Franks Challenges to Electronic Interceptions

Franks and Title III Challenges

Under the Fourth Amendment, a defendant may challenge a search conducted pursuant to a warrant on the grounds that the warrant affidavit, even though facially adequate to support probable cause, contained factual misstatements or omissions that influenced the issuing magistrate.[51] If the reviewing court determines that an affiant has knowingly or recklessly included false information that is material to the determination of probable cause, evidence seized pursuant to that warrant must be suppressed.[52]

This reasoning applies with equal force to wiretap affidavits.[53] The Franks legal analysis in the context of a wiretap motion is similar to the Franks approach to a search warrant. One significant difference is the impact of the omissions or misstatements upon the government's application; in a wire motion, a Franks error may jeopardize not only probable cause, but also necessity for the wiretap.[54]

A defendant seeking a Franks hearing must make a "substantial preliminary showing"[55] that (1) the affidavit contains a material misrepresentation, (2) the affiant made the misrepresentation knowingly and intentionally, or with reckless disregard for the truth, and (3) the allegedly false statement was material to the finding of probable cause.[56] Where the defendant asserts that the affiant omitted facts with a reckless disregard for the truth, the defendant can satisfy the substantial preliminary showing standard by demonstrating that "an officer recklessly omit[ed] facts that any reasonable person would want to know."[57] If the defendant makes this preliminary showing, but "there remains sufficient content in the warrant affidavit to support a finding of probable cause, no hearing is required."[58] If "the remaining content is insufficient," then the defendant is entitled to a hearing.[59]

Taint from Previous Wiretaps

If an original wiretap was improvidently granted, the government cannot use the fruits of that wiretap to obtain authorization for later interceptions.[60]

Practical Considerations

Early Disclosure of Wiretap Applications and Ten-Day Reports

Title III requires that wiretap applications and orders be disclosed ten days before wiretap proceeds are used in any trial, hearing, or other proceeding in a federal or state court.[61] Although this was presumably intended for evidentiary hearings and trial, this disclosure provision has also been held to apply to detention hearings.[62] Early and aggressive invocation of this right can help back government counsel off of relying on wiretap proceeds in bail hearings (as an AUSA rarely has disclosure ready that early in the case).

Early Identification of Cooperating Informants

Wiretaps are expensive and time-consuming, and are typically only used in fairly serious cases. With high federal sentencing exposures, the likelihood that co-defendants will become cooperating witnesses is increased. Once co-defendants cooperate, their names will likely be omitted from any subsequent wiretap application and instead they will be given code names so that their identities will not be disclosed. Every cooperative co-defendant represents a lost opportunity to identify wire informants.

Therefore, in a defense against wiretap evidence, counsel should review the wiretap applications for any references to cooperating witnesses and informants, and develop outlines of their characteristics such that all defendants, co-defendants and counsel can attempt to identify the informants before they are lost to a §5K1.1 deal.

View Hard Copy Originals of All Documents

In a wiretap in the Northern District of California, the government completely failed to attach a referenced affidavit to a wiretap extension application. The application was nonetheless approved.[63] That omission would have never been detected if someone hadn't gone through all of the hard copy applications and affidavits in the district court clerk's office.

Very close review of the materials actually on file can reveal missing (and essential) attachments, applications that were authorized by the DOJ

official after the district court issued the wiretap order, and DOJ authorizations that are missing altogether.

Fight the Recordings Themselves

The transcripts and the recordings themselves are wide open to interpretation. Nobody, especially those who are being surreptitiously recorded, speaks clearly and precisely when speaking in everyday life. They use jargon, and with people whom they have known for years, or possibly decades, they use plenty of inside references. They think out loud. They ask questions. They brainstorm. They joke. When taken out of context, a statement may sound incriminating, while in the context of the relationship with the other party on the line it is perfectly innocent. Any defense counsel defending against wiretaps must listen to every intercept. The defense should learn the context of each conversation in order to understand and explain what the words spoken truly mean. Any help from the client in shedding light on the actual meaning of a potentially incriminating conversation is invaluable.

Most people speak, especially when in private conversation, in a less formal manner than when they speak publicly or with strangers. They do not enunciate as well. They speak in a lazier, or gruffer, or more accented fashion. Their speech becomes casual. Prosecutors, on the other hand, are listening for evidence of crime and can hear things in a speech pattern that does not exist. They are accustomed to interpreting malfeasance, not innocence. If there is doubt as to the clarity of the words recorded, have an inaudibility hearing and get the recording deemed inadmissible.

PRACTICAL ADVICE TO OBTAIN A FRANKS HEARING:

- Get a copy of the warrant, the application for a warrant and affidavits and the inventory.
- Get copies of any police reports regarding the warrant.
- Verify all statements in the affidavits and application for warrant.
- Analyze the application and affidavits for omissions.

- Investigate the affidavit and application allegations.
- Review all documentation with the client.
- File a motion to suppress with a request for Franks hearing.
- Look to prove material, deliberate falsehoods or statements made in reckless disregard for the truth, or omissions of material facts, which affect probable cause.
- Submit a revised affidavit without misstatements and include any omitted material information and argue that the revised affidavit fails to support a probable cause finding.
- Informants -
  - obtain their identities
  - get all police reports of statements
  - get prior jail and criminal records
  - discuss informant with client
- Obtain prior affidavits and applications in other search warrant cases of the officers.
- Obtain copies of prior convictions of persons named in the application.

EXAMPLES OF SUCCESSFUL FRANKS WIRETAP MOTIONS

- *United States v. Novaton* — Affidavit for wiretap falsely stated that four informants had been reliable in the past and failed to include statements about the animosity between informants and target.[64]
- *United States v. Rice* — Suppressing wiretap because of reckless statements in affidavit.[65]

THE FUTURE — FCPA APPLIED TO PHARMACEUTICALS

The possibilities of fake doctors or fake sales representatives conducting sting operations in order to ensnare one another are not so unrealistic.

Given state run health care systems, the range of foreign officials covered by the FCPA are substantial. In some countries the entire health care system may involve "foreign official[s]" under the FCPA.

In Assistant Attorney General Lanny A. Breuer's November 12, 2009 address to Pharmaceutical Regulatory and Compliance Congress and Best Practices Forum he stated that the DOJ is meshing resources in the fraud section's health care and FCPA silos, and department officials said they have met with overseas counterparts to coordinate for their cooperation in the effort.

Said Breuer:

> In the pharmaceutical context, we have additional expertise that significantly enhances our ability to proactively investigate and prosecute these often complex cases. That additional expertise is located in our health care fraud group, where we have prosecutors and analysts with the industry knowledge necessary to quickly identify corrupt practices. These two groups — our FCPA unit and our health care fraud unit — are already beginning to work together to investigate FCPA violations in the pharmaceutical and device industries in an effort to maximize our ability to effectively enforce the law in this area.

CONCLUSION

The expansion of surveillance and sting operations into new areas of criminality reflects a shift in resources and attitudes toward white collar crime. As the DOJ melds the expertise it has in prosecution of these cases, the defense bar must step up its game to properly defend these types of cases. By melding expertise in handling government investigations into corporate practices with experience in defending against overbroad and illegal wiretaps we can provide the best defenses available for our clients.

NOTES

[1] Various resources were used to develop many of the strategies contained herein including, "Uncle Sam is on the Line" by Steven Kalar and Josh

Cohen," "The Criminal Lawyer" blog, and various materials developed by and available through the Office of Defender Services — Training Branch.

[2] *See United States v. Dalia*, 441 U.S. 238, 250 n.9, 252 (1979).

[3] *See Gelbard v. United States*, 408 U.S. 41, 48 (1972).

[4] 18 U.S.C. § 2511(1).

[5] *See, e.g., United States v. Carneiro*, 861 F.2d 1171, 1176 (9th Cir. 1988) ("The district court erred in failing to examine each wiretap application separately. Each wiretap application, standing alone, must satisfy the necessity requirement."); *U.S. v. Majeed*, 2009 WL 2393439, 13 (E.D.Pa. 2009)(showing a thorough wiretap by wiretap analysis).

[6] *See, e.g., United States v. Meling*, 47 F.3d 1546, 1551-52 (9th Cir. 1995) ("Looking only to the four corners of the wiretap application, we will uphold the wiretap if there is a substantial basis for these findings of probable cause.").

[7] 18 U.S.C. § 2518(1).

[8] 18 U.S.C. § 2518(4).

[9] *See, e.g.*, *United States v. Giordano*, 416 U.S. 505, 525-26 (1974) (upholding suppression when wiretap application was not approved by designated official, but by Attorney General's Executive Assistant); *United States v. Chavez*, 416 U.S. 562 (1974) (suppressing wiretap proceeds when application had not been approved by Attorney General or designated Assistant Attorney General); *United States v. Traitz*, 871 F.3d 368, 379-80 (3rd Cir. 1989) (upholding wiretaps when contested application and order identified the authorizing official by title, but not by name); *United States v. Camp*, 723 F.2d 741, 744 (9th Cir. 1984) (permitting the Attorney General to designate the Assistant Attorney General by job title rather than name); *United States v. Citro*, 938 F.2d 1431, 1435 (1st Cir. 1991) (permitting the Attorney General to designate Assistant A.G.'s by title, rather than by name).

[10] 18 U.S.C. § 2518(8)(a).

[11] *United States v. McGuire*, 307 F.3d 1192, 1202-03 (9th Cir. 2002) (*citing United States v. Pedroni*, 958 F.2d 262, 265 (9th Cir. 1992)); *see also U.S. v. Quintero*, 38 F.3d 1317 (3d Cir. 1994) (hectic trial schedule is the norm for federal prosecutors and is not a satisfactory explanation for failure to seal wiretap tapes immediately).

[12] 18 U.S.C. § 2518(5).

[13] *United States v. Hull*, 456 F.3d 133, 142 (3d Cir. 2006) (*citing Scott v. United States*, 436 U.S. 128, 140 (1978)).

[14] *Scott*, 436 U.S. at 132-33. *See also*, *United States v. Vento*, 533 F.2d 838,

854 (3d Cir. 1976) ("Minimization is not to be judged by a rigid hindsight that ignores the problems confronting the officers at the time of the investigation.").
[15] *Scott*, 436 U.S. at 140.
[16] *Hull*, 456 F.3d at 143 (*citing* to *United States v. Adams*, 759 F.2d 1099, 1115 (3d Cir. 1985)).
[17] *United States v. Armocida*, 515 F.2d 49, 52 (3d Cir. 1975).
[18] *Id*. at 52-53.
[19] *Id*.
[20] *Id*.
[21] *Id*.
[22] *Hull*, 456 F.3d at 142.
[23] *Armocida*, 515 F.2d at 44.
[24] *Id*.
[25] *Scott*, 436 U.S. at 140.
[26] *Armocida*, 515 F.2d at 44.
[27] *Id*. at 44-45.
[28] 462 F.2d 1293, 1302 (8th Cir. 1972), *cert. denied*, 417 U.S. 918, 94 S.Ct. 2623, 41 L.Ed.2d 223 (1974).
[29] 336 F. Supp. 190, 196 (W.D.Pa. 1971).
[30] 18 U.S.C. § 2518(l)(c).
[31] 18 U.S.C. § 2518(3)(c)(3).
[32] *United States v. Ippolito*, 774 F.2d 1482, 1485 (9th Cir. 1985).
[33] *United States v. Kahn*, 415 U.S. 143, 153 & n.12 (1974); *see also United States v. Williams*, 124 F.3d 411, 418 (3d Cir. 1997) and *United States v. Armocida*, 515 F.2d 29, 38 (3d Cir. 1975).
[34] *United States v. McGlory*, 968 F.2d 309, 345 (3d Cir. 1992).
[35] *See United States v. Ippolito*, 774 F.2d 1482, 1485 (9th Cir. 1985), wherein the officer did not include that the confidential informant was cooperating in the investigation and willing to testify.
[36] *See generally* S. REP. 90-1097, 1968 U.S.C.C.A.N. 2112, 2190 ("The judgment would involve a consideration of all the facts and circumstances. Normal investigative procedure would include, for example, standard visual or aural surveillance techniques by law enforcement officers, general questioning or interrogation under an immunity grant, use of regular search warrants, and the infiltration of conspiratorial groups by undercover agents or informants.").
[37] *Ippolito*, F.2d at 1486; *see also U.S. v. Teagle*, 2007 WL 2972554 (E.D.Pa.

2007).
[38] *United States v. Ashley*, 876 F.2d 1069, 1072 (1st Cir. 1989). *See also U.S. v. Teagle*, 2007 WL 2972554 (E.D.Pa. 2007) at *4 explaining the specificity of an application.
[39] *See U.S. v. Majeed*, 2009 WL 2393439, at *11 (E.D.Pa. 2009).
[40] 18 U.S.C. § 2518(f).
[41] *U.S. v. Majeed*, 2009 WL 2393439, at *11 (E.D.Pa. 2009).
[42] *Giordano*, 416 U.S. at 530.
[43] *Id*.
[44] *Id.*
[45] 18 U.S.C. § 2518(3)(a)(b) & (d).
[46] 18 U.S.C. § 2518(3)(a).
[47] 18 U.S.C. § 2518(3)(b).
[48] 18 U.S.C. § 2518(3)(d).
[49] *United States v. Urban*, 404 F.3d 754, 774 (3d Cir. 2005).
[50] *Id*. at 775.
[51] *See Franks v. Delaware*, 438 U.S. 154 (1978).
[52] *See U.S. v. Majeed*, 2009 WL 2393439, at *13 (E.D.Pa. 2009).
[53] *United States v. Ippolito*, 774 F.2d 1482, 1485 (9th Cir. 1985); *Majeed*, 2009 WL 2393439, 13 (E.D.Pa. 2009).
[54] *See, e.g.*, *Ippolito*, 774 F.2d at 1485 ("The necessity showing and finding are therefore material to the issuance of a wiretap order and are subject to Franks.").
[55] *Franks*, 438 U.S. at 170.
[56] *See id*. at 155-56, 171; *see also United States v. Brown*, 3 F.3d 673, 676 (3d Cir. 1993).
[57] *United States v. Yusuf*, 461 F.3d 374, 383 (3d Cir. 2006) (citing *Wilson v. Russo*, 212 F.3d 781, 783 (3d Cir. 2000)).
[58] *Id*. at 171–172.
[59] *Id*. at 172.
[60] *See, e.g.*, *United States v. Giordano*, 416 U.S. 505, 529-30 (1974) ("Even though suppression of the wire communications intercepted under the October 16, 1970, order is required, the Government nevertheless contends that communications intercepted under the November 6 extension order are admissible because they are not 'evidence derived' from the contents of communications intercepted under the October 16 order within the meaning of § § and 2518(10)(a). This position is untenable."); *United States v. Vento*, 533

F.2d 838, 847 (3d Cir. 1976) ("If the government's application did not present probable cause for the authorization of the interception, then the authorization and any surveillance pursuant to it were improper. And, if the surveillance was improper, the government could not use the fruits of that surveillance at trial or to further its investigation.").

[61] *See* 18 U.S.C. § 2518(9).

[62] *See United States v. Salerno*, 794 F.2d 64 (2d Cir. 1986), rev'd on other grounds, 107 S. Ct. 2095 (1987) ("We think it clear that Congress intended § 2518(9) to apply to detention hearings.").

[63] See *U.S. v. Callum*, 410 F.3d 571 (9th Cir. 2005) (showing the difficulty in challenging a wiretap that is is flawed on its face, "Under the force of precedent, we uphold the challenged wiretap applications and orders. Still, we note that the Department of Justice and its officers did not cover themselves with glory in obtaining the wiretap orders at issue in this case."). *Id* at 577.

[64] 271 F.3d 968 (11th Cir. 2001).

[65] 478 F3d 704 (6th Cir. 2007).

What Foreign Banks Need to Know About the Foreign Corrupt Practices Act

THOMAS E. CROCKER

In this article, the author discusses the basic provisions of the Foreign Corrupt Practices Act and highlights particular areas of compliance concern for foreign banks.

A variety of regulatory and enforcement strands suggest that the U.S. Foreign Corrupt Practices Act of 1977, as amended ("FCPA"),[1] may join anti-money laundering ("AML") and Office of Foreign Assets Control ("OFAC") as an area of heightened compliance concern for foreign banks. This article discusses the basic provisions of the FCPA and highlights particular areas of compliance concern for foreign banks.

SUMMARY OF REQUIREMENTS AND JURISDICTION UNDER THE FCPA

Anti-Bribery Prohibitions

The FCPA is a U.S. criminal statute that prohibits improper payments to, or other improper transactions with, non-U.S. officials to influence the performance of their official duties. In general, the anti-bribery provisions of the FCPA prohibit giving, paying, promising, offering or authorizing the payment of anything of value, directly or indirectly through a third

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party, to any "foreign official" (a term that is very broadly defined) or to a foreign political party, party official or candidate to obtain or keep business or to secure some other improper advantage. The Department of Justice ("DOJ") enforces the anti-bribery provisions.

Accounting and Recordkeeping Requirements

In addition to prohibiting bribery, the FCPA requires companies whose shares are traded on U.S. exchanges ("issuers") and their *majority*-owned affiliates to maintain adequate internal controls and to keep accurate and complete records of the transactions in which they engage. The FCPA also requires those companies to make good-faith efforts to cause the ventures in which they own *minority* interests to keep such records and proper internal controls. The U.S. Securities and Exchange Commission ("SEC") enforces the accounting and recordkeeping provisions, normally in close consultation with the DOJ.

Jurisdiction

The FCPA applies to U.S. persons or business entities anywhere in the world, to "issuers" of securities regulated by the SEC, and, more broadly, to any U.S. person who performs an act anywhere in the world "in furtherance of" a prohibited bribe. Individual U.S. nationals and residents remain subject to the FCPA regardless of where they are employed or with whom they are working. Such employees associated with non-U.S. companies — either through temporary assignment, secondment, serving on the boards of directors of non-U.S. companies or otherwise — remain individually subject to the FCPA even if the non-U.S. companies are not. In such circumstances, there is a risk that the individual employee or the U.S. parent company may be held accountable for actions taken by the non-U.S. company.

Applied to foreign banks, the above jurisdictional concepts have several implications. First, the anti-bribery provisions apply to U.S. operations of foreign banks because they are "domestic concerns" subject to the FCPA.[2] Second, and separately, both the anti-bribery provisions and the accounting and recordkeeping provisions of the FCPA apply to both the U.S. *and non*-U.S. operations of any foreign bank that is deemed to be an "issuer" under

the FCPA, such as by having its American Depository Receipts ("ADRs") traded on a U.S. stock exchange. Third, the anti-bribery provisions potentially apply to "any" non-U.S. person who is not an "issuer" or "domestic concern" (such as a non-issuer foreign bank) acting outside the United States who may only tangentially use U.S. mails, telecommunications or banking servers "in furtherance of" a foreign bribe. Fourth, under the "alternative jurisdiction" provisions of the FCPA, the anti-bribery provisions prohibit any U.S. person (such as a U.S. office of a foreign bank) from corruptly doing "any act outside the United States in furtherance of" a bribe, irrespective of whether the U.S. person makes use of the mails or any means or instrumentality of interstate commerce in the United States in furtherance of the bribe. A separate but related "alternative jurisdiction" provision similarly applies the same prohibition, irrespective of the use of U.S. jurisdictional means, to any "agent" of an "issuer" organized under U.S. law, thereby potentially reaching foreign banks that service U.S. customers who are themselves issuers and who pay bribes.

Clearly, foreign banks need to be alert to the FCPA's prohibitions, both as they apply directly to their own operations and as they apply to their role in transactions by their customers which they may be facilitating.

SUMMARY OF PROHIBITIONS UNDER THE FCPA

Elements of an FCPA Bribery Violation

The FCPA prohibits every person or entity described above from giving, paying, promising, offering or authorizing the payment of anything of value to any foreign official (or to any other person while knowing it would be offered, promised or given to a foreign official) to persuade that official to help obtain or retain business or obtain an improper advantage.

The FCPA bars such payments even if:

- the benefit is for someone other than the person making the payment;
- the business sought is not with the government;
- the payment does not actually result in business being awarded or an advantage being obtained; or

- the foreign official initially suggests the payment.

Foreign Officials

As noted above, the term "foreign official" under the FCPA is broadly defined. It means any officer or employee of a non-U.S. government or of any department, agency or instrumentality thereof, or of a designated public international organization, or any person acting in an official capacity for or on behalf of any such government or department, agency or instrumentality, or for or on behalf of any such public international organization.

For purposes of the FCPA, public international organizations are designated from time to time by executive order of the President of the United States. The current list includes the United Nations, the World Bank, the International Monetary Fund, the International Red Cross, the World Trade Organization and many other organizations. Many of these international organizations have their own anti-corruption rules separate from the FCPA. Sanctions typically include debarment. Recently, the World Bank and four regional development banks announced plans to blacklist jointly any company that any one of the banks finds guilty of bribery or collusion.

Foreign officials include employees and representatives of non-U.S. government departments of agencies, whether in the executive, legislative or judicial branch of a government, and whether at the national, state or local level. Foreign officials also include officers and employees of commercial companies under non-U.S. government ownership or control. The basic FCPA prohibitions also apply to any non-U.S. political party or official thereof and any candidate for non-U.S. political office.

In some instances, foreign officials are not treated as government officials by their own governments, and they expect to be treated like any other private business person. For purposes of the FCPA, however, it is legally irrelevant whether a person is considered a government official by the government at issue. The U.S. law definition controls.[3]

Anything of Value

The law prohibits offering, promising or giving anything of value to a foreign official to get or keep business or secure an improper advantage.

Thus, the prohibition is not limited to cash payments. Anything of value may include:

- gifts;
- entertainment;
- business activities; or
- covering or reimbursing expenses of officials.

In addition, less obvious items provided to foreign officials can violate the FCPA. For example, in-kind contributions, investment opportunities, subcontracts, stock options, positions in joint ventures, favorable contracts for relatives, charitable donations, scholarships for children and similar items provided to or for the benefit of foreign officials are all things of value that can violate the FCPA.

Exceptions

Minor (and narrowly construed) exceptions apply for (i) "facilitation" or "grease" payments to low-ranking government officials relating to non-discretionary, ministerial functions such as police protection, mail delivery, business permits, etc. (although efforts are currently under way to eliminate this exception); (ii) "reasonable and bona fide expenditures" directly related to the "promotion, demonstration or explanation of a product or service or for the execution or performance of a contract;" and (iii) payments that are lawful under the written laws of a foreign country (even though payments to government officials may be "common" or "traditional" in some countries, almost all countries, especially those that have adhered to the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions (the "OECD Convention"), have written laws that prohibit bribery of government officials).

LONG REACH OF THE FCPA

Through Use of U.S. Jurisdictional Means

Section 78dd-3 of the FCPA applies the anti-bribery provisions under

certain circumstances to entities that are neither "domestic concerns" nor "issuers," but are simply "any person." Thus, Section 78dd-3(a) states that "[i]t shall be unlawful for any person other than an issuer that is subject to Section 30A of the Securities and Exchange Act of 1934 or domestic concern…or for any officer, director, employee, or agent of such person or any stockholder thereof acting on behalf of such person, *while in the territory of the United States* [emphasis added]," to make illicit payments prohibited by the FCPA. This provision was added to the FCPA in 1998 to implement the OECD Convention by expanding the FCPA's coverage to foreign companies that take an act in furtherance of the bribe of a foreign official while in the United States.

Thus, any foreign bank entity outside the United States or any of its non-U.S. person officers, directors, employees, etc. could run afoul of the FCPA if it or they were to engage in prohibited conduct "while in the territory of the United States." Leveraging its enforcement jurisdiction, DOJ has made clear in the context of pending enforcement cases that it will find activity "in the territory of the United States" through such tangential means as use of U.S. mails or telecommunications facilities. U.S. Dollar clearing or other banking or data processing transactions in connection with prohibited activity would almost certainly qualify to confer jurisdiction. Indeed, in the pending *Technip* settlement and other cases, the DOJ reportedly has asserted jurisdiction based on U.S. Dollar transfers between foreign banks via the use of correspondent accounts in the United States.

Accordingly, there is a material risk that FCPA-prohibited activities by non-U.S. persons otherwise outside the United States, but which only tangentially touch the United States through the use of the U.S. mails or telecommunications facilities (including emails) or through banking or data processing transactions, could be subject to prosecution by DOJ.[4]

WITHOUT USE OF U.S. JURISDICTIONAL MEANS

Two separate but related provisions extend jurisdiction even further under the FCPA's "alternative jurisdiction" provisions. The first, Section 78dd-2(i), prohibits any "United States person" (such as a U.S. office of a foreign bank) from corruptly doing "any act outside the United States

in furtherance of" a bribe, irrespective of whether the U.S. person makes use of any means or instrumentality of U.S. interstate commerce in furtherance of the bribe. The second, Section 78dd-1(g), applies the same prohibition on acts outside the United States "in furtherance of" a bribe to any "agent" of an "issuer" organized under U.S. law, irrespective of the use of U.S. jurisdictional means. Taken together, these prohibitions could reach either the U.S. or non-U.S. operations of a foreign bank in conducting banking transactions that involve, however tangentially, payment of a bribe by the bank's customer.

PENALTIES

Criminal penalties under the FCPA include fines of up to $25 million and imprisonment for up to 20 years per violation. However, recent settlements, such as those involving *Siemens AG* (December 15, 2008), *BAE Systems plc* (March 1, 2010) and *Daimler AG* (April 1, 2010), have involved much higher criminal penalties ($1.6 billion, $400 million and $93.6 million, respectively).

As the pace of enforcement has increased dramatically in the last five years and fines have reached well into the hundreds of millions of dollars or more, the DOJ also has increasingly pursued aggressive and even novel theories of enforcement and remedies. A major recent trend has been to target and imprison individual officers and directors for FCPA violations. As recently stated by Assistant Attorney General for the Criminal Division Lanny Breuer, "Put simply, the prospect of significant prison sentences for individuals should make clear to every corporate executive, every board member and every sales agent that we will seek to hold you personally accountable for FCPA violations." The FCPA prohibits companies from indemnifying their employees.

Current enforcement trends include additional measures such as disgorgement of profits and imposition of mandatory compliance monitors on companies that violate the Act. A company can suffer serious consequences even if it is not convicted and the statutory penalties are not brought into play — mere indictment under the FCPA may trigger significant sanctions. Also, FCPA prosecutions often include charges of other

criminal violations, such as mail and wire fraud and conspiracy, and may lead to civil claims against the company. FCPA violations, moreover, can trigger investigations by non-U.S. governments, with the risk of both penalties under local laws and loss of goodwill. (Along with heightened levels of cooperation with the U.S. enforcement authorities, non-U.S. anti-corruption enforcement agencies, such as the U.K.'s Serious Fraud Office, recently have taken a notably more assertive stance on enforcement of their own laws.) Further, in certain cases, admission of FCPA violations can trigger debarment procedures under EU law. Therefore, banks with significant EU business and potential exposure to debarment under EU law may have an additional incentive to ensure that they do not violate the FCPA. However, concern should not be limited to EU business exposure, as a number of recent enforcement actions (such as the *Daimler AG* case noted above) involve BRIC countries, and many pending investigations focus on companies in the BRIC markets.

FCPA AS A NATIONAL SECURITY ISSUE

Perhaps most germane to foreign banks, statements over the last six months by senior DOJ and SEC officials responsible for enforcing the FCPA make clear that the cognizant U.S. authorities increasingly view corruption as a national security issue. Such officials have repeatedly pointed to what they view as the connection between illicit money and terrorism. Therefore, in the minds of the U.S. authorities, the FCPA is increasingly linked with AML and OFAC enforcement as a counter-terrorism measure. This trend has been facilitated by greater interagency cooperation by U.S. authorities on enforcement issues generally. Taking a page from the DOJ's Export Control Initiative established in 2007, which set new standards for interagency coordination and training of prosecutors nationwide to bring export control cases, the Fraud Section of the DOJ, which administers FCPA enforcement, has increasingly sought linkages with other enforcement priorities. For example, senior DOJ officials have publicly stated in recent months that they often find FCPA violations in the context of investigating other criminal activities, such as export control or OFAC violations. A recent example of this increased coordination is the

BAE Systems plc plea agreement, which involved allegations of both illicit payments and U.S. export control violations and was prosecuted jointly by DOJ's Criminal Division Fraud Section and DOJ's National Security Division Counterespionage Section.

Moreover, increased assets devoted to FCPA prosecution have given teeth to this broadening cooperation. Mark Mendelsohn, until earlier this month the deputy chief of DOJ's Fraud Section and the senior official responsible for FCPA prosecutions, recently stated that his office could grow by as much as 50 percent over the next two years. Similarly, the SEC's Division of Enforcement recently announced the creation of a specialized team dedicated to FCPA enforcement staffed with between 25 and 30 personnel. Members of the SEC's FCPA team will be located all over the country (similar to the approach followed in DOJ's Export Control Initiative), and senior SEC officials have indicated that it will follow DOJ's lead in targeting specific industries for enforcement. (DOJ has publicly stated that it will scrutinize the medical devices and telecommunications industries, and recent indications are that the defense and law enforcement products industries also might be targets.)

Furthermore, DOJ officials have publicly stated that they will increasingly seek to indict foreign officials or beneficiaries of bribes on money laundering or other charges. The linkage between illicit foreign payments and the banking industry was highlighted in particular by a February 4, 2010, hearing and accompanying bipartisan report released by the Senate Permanent Subcommittee on Investigations, which focused on the use by corrupt foreign officials of the U.S. banking system (including foreign banks operating in the United States) to funnel significant illicit money into the United States. Subcommittee Chairman Senator Carl Levin (D-MI) explicitly called corruption "a direct threat to our national interest" and made further connections between the use of laundered money to train and provide support for terrorists. The report recommended, among other things, stronger controls on PEP accounts and greater disclosure of beneficial owners of accounts. The issue of foreign corruption and its use of the U.S. banking system has therefore received significant political-level attention in Congress and is likely to be the subject of continuing and increased scrutiny.

HIGHER EXPECTATIONS ON TRANSACTIONAL DILIGENCE

Drive-by DOJ and SEC enforcement decisions, one of the most pronounced trends over the last several years, have been the rapidly rising bar of the U.S. government's expectations on standards for transactional due diligence in the anti-corruption context. The enforcement agencies have come to expect credible due diligence programs on foreign agents, business partners, joint venture participants, acquisition targets (the DOJ and SEC apply successor liability) and similar parties that involve such measures as:

- routine and renewable vetting of such entities by persons subject to the FCPA on a risk-based approach, paying particular attention to high-risk countries;
- use of background questionnaires, anti-corruption compliance declarations or representations and warranties, as well as third-party investigatory services;
- periodic renewals of diligence to ensure that approved status is current;
- audit rights over relevant transactions by foreign partners;
- clear processes for identifying and responding to "red flag" indicators; and
- secure retention in the United States of documentation on FCPA due diligence for ready reference.

RESPONSE BY U.S. REGULATORS

As FCPA compliance standards have risen rapidly over the last several years, driven by a stream of enforcement cases, the bank regulators to date have in a sense been playing "catch up," which may result in some foreign banks not being as aware as they might be of these recent changes. However, even under existing bank regulatory requirements (which may be tightened in the future), foreign banks subject to the FCPA are required to meet these evolving standards, as articulated by enforcement cases. Thus,

the Federal Reserve Board's *Bank Holding Company Manual*, the Comptroller's *Handbook for Directors* and *Handbook for Payment Systems*, the Federal Financial Institutions Examination Council's *Examination Procedures* and the Federal Deposit Insurance Corporation's *Guidance on Foreign Corruption* all contain requirements in one formulation or another that mandate the supervised institution to have in place a compliance program that meets FCPA concerns. For example, Section 5070.3 of the Federal Reserve Board's *Branch and Agency Examination Manual* requires that the examiner, *inter alia*, "[d]etermine whether the branch has a policy prohibiting improper or illegal payments, bribes, kickbacks or loans" covered by the FCPA and "…analyze any internal or external audit program employed by the branch to determine…appropriate routines to identify improper or illegal payments under the" FCPA.

RECOMMENDATIONS FOR FOREIGN BANKS

Given the trends described above and the dual nature of the risks posed both to the banks' own operations and to the banks' support of transactions by their customers, we recommend that foreign banks, particularly those operating in the United States, pay increased attention to FCPA compliance as part of their compliance agenda. As a practical matter, this minimally might include adoption of an FCPA compliance program addressing such issues as diligence on foreign agents, business parties and transactions (including on PEPs, lending, trade finance and transactional partnering).

Such a compliance program might appropriately include the following:

- Risk assessments to measure the likelihood and scope of possible violations in order to deploy compliance assets appropriately.
- High-level adoption and issuance of a clear corporate compliance and ethics policy that spells out the bank's commitment to complying with the FCPA and foreign anti-corruption measures such as the OECD Convention. The compliance policy should detail comprehensive standards and procedures for bank personnel, external partners and third parties.
- Dedication of a compliance officer responsible for ensuring that compliance occurs in fact.

- Periodic training and audits to help instill a culture of compliance and assess performance.
- A consistent due diligence template for vetting third parties that uses investigative "best practices," secure document retention and appropriately nuanced levels of inquiry based on articulated standards and risk profiles.
- An effective "whistleblower" mechanism.

Foreign banks may also wish to review their transactional documentation to ensure that appropriate representations and warranties are obtained regarding compliance with the standards contained in the FCPA and the OECD Convention.

NOTES

[1] 15 U.S.C. §§ 78dd-1 *et seq*.

[2] Section 78dd-2(h) of the FCPA defines a "domestic concern" to include, *inter alia*, "any corporation, partnership, association, joint stock company, business trust, unincorporated organization or sole proprietorship which has its principal place of business in the United States or otherwise is organized under the laws of a State of the United States …." Setting aside any argument that a foreign branch in the United States is the foreign bank itself, there is little question that the DOJ would view a foreign bank branch in the United States as a "domestic concern."

[3] The FCPA prohibits improper payments to individual foreign officials. Good faith payments to a government entity, such as payments to the host country's federal treasury required by contract or law, are not prohibited, provided they are made with due care to the government entity and not to any individual official.

[4] DOJ has in fact brought several publicly reported cases against non-U.S. companies solely on the basis of Section 78dd-3(a). For example, in 2004, DOJ prosecuted and fined ABB Vetco Gray U.K. Ltd. and related companies $5.25 million for violation of Section 78dd-3 of the FCPA. Notwithstanding the penalty, the non-U.S. companies involved continued to make payments in violation of the FCPA and were penalized a second time in 2007 — this time for $26 million — under the same authority.

Internal Investigations in the United Kingdom

KAROLOS SEEGER AND TOM EPPS

Newly enacted laws and laws that are planned for the future will give authorities more powers and are likely to make for a fundamental change in the approach to, and practice of, corporate internal investigations in the United Kingdom. In this article, the authors review this timely, important topic.

Corporate internal investigations are historically less common in the United Kingdom than in the United States. This is a result of both the absence of legislation calling for such investigations but, also, of an approach to enforcement by the U.K. regulators and prosecutors which — unlike the approach of their U.S. counterparts — did not, until recently, incentivize companies to self investigate and self report. There are now clear signs that both the legislative landscape and the approach to enforcement have changed and will continue to change very significantly. This is particularly so in the field of anticorruption, where an increase in corporate internal investigations can be expected. It is of particular note, in this context, that Richard Alderman, Director of the Serious Fraud Of-

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fice ("SFO"), the lead agency responsible for investigating and prosecuting cases of serious fraud and corruption, recently stated:

> What I want to see in suitable cases is corporates identifying a corruption issue and then bringing in their advisers to conduct a rigorous investigation. At some point in this process (and views vary as to when) I want the corporate to engage us about a suitable resolution.[1]

His remarks are indicative of the SFO's new "carrot and stick" approach, where tougher enforcement actions will be complemented by a culture in which self investigating and self reporting corruption is very seriously encouraged. Similar pronouncements forecasting a more robust approach have been made by the Financial Services Authority ("FSA"), the United Kingdom's financial services regulator. Both the SFO and the FSA have already increased their staff by 20-30 percent, which included the hiring of a well known criminal QC by the SFO and the former Director of the Fraud Prosecution Service (a division of the Crown Prosecution Service) by the FSA. The SFO has set up a separate work unit for its anticorruption efforts (the Anti-Corruption Domain), to which it is dedicating significant resources and which it expects to increase to a staff of 100. New laws already enacted and future laws that are planned will give the authorities more powers and are likely to make for a fundamental change in the approach to, and practice of, corporate internal investigations in the U.K.

U.K. LAWS THAT COULD TRIGGER AN INVESTIGATION

Allegations of corporate wrongdoing that trigger internal investigations can stem from a wide variety of sources, but commonly include:

- Tipoffs from company whistleblowers;
- A company's self reporting to the regulator;[2]
- A Suspicious Activity Report made to the Serious Organized Crime Agency ("SOCA") by either the company or a third party;[3] or
- The findings of an internal or external audit.

The U.K. has four different laws relating to the prosecution of corruption, in addition to the common law offense of bribery:

- The Public Bodies Corrupt Practices Act 1889;
- The Prevention of Corruption Act 1906;
- The Prevention of Corruption Act 1916; and
- The Anti-Terrorism, Crime and Security Act 2001.

The 1889, 1906 and 1916 Acts together apply both to public bribery but also to bribery in the private sphere. Unlike U.S. corrupt practices laws, the U.K. bribery offenses are broadly based on an agency concept, the relevant test being the corrupt giving or agreeing to give consideration to an agent (or conversely, the receiving or agreeing to receive such consideration by the agent) as an inducement or reward for doing or omitting to do any act in relation to his principal's affairs.

Section 108 of the Anti-Terrorism, Crime and Security Act 2001 seeks to give effect to the U.K.'s obligation under the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions to criminalise the bribery of foreign public officials. The 2001 Act applies equally to public and private bribery. It provides that if a U.K. national (or a body incorporated under U.K. law) performs any act outside the U.K. which would, if performed in the U.K., be a corruption offense, then that person is liable in exactly the same way as if the offense had been committed within the U.K. Until its enactment in 2001, the U.K. bribery laws did not have extraterritorial application. In addition, the U.K. has the following laws:

- Suspicions of the commission of any of the money laundering offenses set out in the Proceeds of Crime Act 2002.
- Allegations of market abuse contrary to sections 118 or 397 of the Financial Services and Markets Act, or other allegations of breaches of the financial regulatory regime, such as the FSA's Principles for Businesses.
- Allegations of breaches of European Union and U.K. competition law, such as the Competition Act 1998 and the Enterprise Act 2002.[4]

U.K. ENFORCEMENT AUTHORITIES

The enforcement authorities charged with investigating breaches of these laws are:

Serious Fraud Office

The SFO is the lead investigating agency for cases of serious fraud and corruption, and in particular overseas corruption. The SFO is a governmental department and accountable to the attorney general. The SFO has jurisdiction over England, Wales and Northern Ireland, but not Scotland, the Isle of Man or the Channel Islands.

The SFO is empowered to investigate any suspected offense which the Director of the Serious Fraud Office considers on reasonable grounds to constitute serious or complex fraud. The SFO's key criterion for whether to accept a case is that the suspected fraud must appear so serious and complex that its investigation should be carried out by those responsible for its prosecution.[5] The SFO has the power to conduct such investigations independently, or in conjunction either with the police or any other person that the Director considers appropriate. The SFO also may require a person to answer questions, provide information or produce documents for the purposes of an investigation.

In addition to carrying out investigations, the SFO is also empowered to prosecute cases of serious or complex fraud, or to take over the conduct of such proceedings at any stage.[6] The SFO may seek civil and criminal remedies, including Civil Recovery Orders (CROs), which can be issued following a determination that property has been obtained as a result of unlawful conduct.[7]

On September 25, 2009, the SFO announced its first successful prosecution of a company for overseas corruption, when the bridge building firm Mabey & Johnson was fined £6.6 million after it admitted paying bribes to public officials in Jamaica and Ghana and breaching United Nations sanctions.[8]

Financial Services Authority

The FSA is responsible for enforcing the Financial Services and Mar-

kets Act ("FSMA"), together with the FSA's own rules.[9] More generally, however, the FSA is obliged to fulfil its four statutory objectives (set out in FSMA), among which is to reduce financial crime. This can lead to the FSA taking a role in cases which involve neither FSMA nor the FSA's rules, such as insider dealing contrary to Part V of the Criminal Justice Act 1993. In carrying out its objectives, the FSA can act both as a regulator (for example, by imposing financial penalties for market abuse, withdrawing a firm's authorization or disciplining authorized firms and authorized persons) and as an investigator and prosecutor. (For example, by applying to the court for injunction and restitution orders, and prosecuting the criminal offenses of insider dealing and market abuse.) It appears that, in appropriate cases, the FSA will work in conjunction with the SFO, although there is no formal memorandum of understanding between the two agencies.[10]

Serious Organized Crime Agency

The Serious Organized Crime Agency ("SOCA") is an executive body sponsored by, but operationally independent from, the Home Office. SOCA has the power to institute criminal proceedings in England, Wales and Northern Ireland, and to act in support of the activities of any police force or law enforcement agency, if so requested.

SOCA's responsibilities include fighting organized crime and the proceeds of crime, both of which are relevant in the context of investigations. In relation to organized crime, SOCA focuses on fraud and money laundering carried out by organized gangs. As for the proceeds of crime, SOCA's key role is to receive and investigate Suspicious Activity Reports ("SARs"). Such reports form part of the U.K.'s anti-money laundering regime, and can be made as soon as there is a suspicion by a designated reporter that criminal proceeds exist. It is notable that the £5.25 million fine which was imposed on Aon Ltd. by the FSA in January 2009 followed the issuance of an SAR to SOCA.[11]

Office of Fair Trading

The Office of Fair Trading ("OFT"), a non-ministerial government department, is the U.K.'s competition regulator. Like the FSA, the OFT

has the power to act as a regulator (for example by imposing heavy fines) and as an investigating authority.

CONDUCTING AN INTERNAL INVESTIGATION IN THE U.K.

Data Protection in the U.K.

The EU Data Protection Directive,[12] which specifies the mandatory protections pertaining to the processing and transfer of personal data, was implemented in the U.K. through the Data Protection Act 1998 ("DPA"). Schedule 1 to this Act sets forth eight data protection principles in relation to personal data, of which the most important are the first and eighth principles. The first principle requires that data be processed fairly and lawfully, while the eighth provides that personal data cannot be transferred to a country or territory outside of the European Economic Area unless: (i) the country or territory in question ensures an "adequate level of protection" for personal data, or (ii) one of the exceptions listed in Schedule 4 to the Act applies.[13]

While the U.K.'s implementation of the EU Directive is broadly in line with that in other Member States, it is appropriate to note that the term "personal data" itself has been interpreted differently in the U.K. than in other EU States. While other EU States have tended to interpret this term broadly, the Court of Appeal in the *Durant*[14] case rejected a very broad understanding of this term (to mean effectively any data capable of identifying a person) and opted for a more restrictive interpretation to the effect that personal data consisted only of information which affected a person's privacy, whether in his personal or family life, business or professional capacity.[15]

Despite this more restrictive definition, however, data protection considerations will still be highly relevant to conducting an internal investigation in the U.K., if this will involve the collection and review of employees' emails and files. In particular, the DPA requirements relating to sensitive personal data[16] and transfer of data to countries outside of the EU will merit careful consideration.

Employment Law

A related topic to that of data protection law is the effect of U.K. employment law on internal investigations. An employer owes a duty of confidentiality to its employees, which is quite separate from any duties owed as a result of the DPA. To the extent that an employer discloses confidential information about employees during the course of an investigation — even if it does not fall within the definition of personal data under the DPA — the employer may have breached its duty to its employee.

Employment law could also impact investigations as a result of the mutual duty of trust and confidence implied in every employment relationship. A breach of this duty by an employer may entitle an employee to resign and claim constructive dismissal. It is therefore advisable to seek employment law advice in order not to fall foul of this duty of trust and confidence in conducting an internal investigation in the U.K.[17]

Attorney-Client Privilege

The principle of legal professional privilege has to be taken into account in determining the scope of information that can be handed over to an investigating authority during the course of an investigation. There are two parts to the U.K. principle of legal professional privilege: legal advice privilege and litigation privilege. For present purposes, legal advice privilege is the most relevant.

Legal advice privilege applies to confidential communications between a party and its lawyer for the purpose of giving or receiving legal advice. The privilege is not confined to telling the client the law; it has also been held to include "*advice as to what should prudently and sensibly be done in the relevant legal context*."[18] This principle would seem to include advice on the presentation of the results of an internal investigation. A lawyer's drafts, working papers and memoranda are also covered by legal advice privilege.[19]

Current case law gives a narrow definition of "client" for these purposes: the "client" has been limited to only those individuals specifically instructed to handle the case or inquiry at issue, rather than the organization as a whole.[20] This point will need to be considered whenever privi-

leged material is distributed by the lawyers conducting the internal investigation.

It is appropriate to note, however, that there are no specific cases applying the principles of privilege in the context of corporate internal investigations. It is, thus, not possible to say with absolute certainty how the rules of legal professional privilege would be applied to internal investigations.

WHISTLEBLOWER PROTECTION AND LENIENCY FOR COOPERATION

Protection of Whistleblowers Vis-à-vis Company

U.K. whistleblowers can be protected from sanctions by their employer if they make certain disclosures which they reasonably believe demonstrate any of a number of situations, including (i) that a criminal offense has been committed; (ii) that malpractice has been committed (or is likely to be committed); or (iii) that a miscarriage of justice has occurred.[21] It is generally contemplated that the disclosures in question be made to the employer itself, or to a prescribed regulator (such as the Financial Services Authority or Her Majesty's Revenue and Customs). However, broader (public) disclosures are also permitted, although a higher threshold has to be crossed in order for such disclosures to be allowed; specifically, the disclosure must not only be made in good faith, but the person making the disclosure must also believe that the information disclosed, and any allegations in it, are substantially true.[22]

Leniency from Authorities Through Cooperation

Historically, plea bargaining has not played a role in the enforcement of criminal laws in the U.K. There are signs that this is changing, with the Attorney General having recently issued guidelines on the conduct of plea bargaining in cases involving serious or complex fraud, replacing the informal system of plea discussions which had existed beforehand (and which still exists in all other cases). These guidelines require the prosecutor to act openly, fairly and in the interests of justice, and set out the process by which the plea discussions ought to be initiated and conducted, which includes

specifying the various documents which should pass between the prosecutor and the defendant. The guidelines envisage that all matters which are agreed between the prosecutor and the defendant should be reduced to a written plea agreement. Together with supporting information, this agreement is then placed before the judge, who then has absolute discretion as to whether the pleas agreed by the parties ought to be accepted.[23]

The recent shift by the SFO towards a regime in which self investigating and self reporting corruption will be viewed as a very major consideration in the decision to prosecute a corporation, as well as discussing pleas with the suspect companies, suggests a growing importance of this issue of plea bargaining.

The SFO issued guidelines in July 2009 on the self reporting of corruption, which provide that if a company self reports instances of corruption, the SFO will take this into account and endeavour to settle the case civilly, rather than criminally, if at all possible.[24] By contrast, if the company does not come forward and the SFO discovers the corruption by other means, this will be treated as a significant negative factor, making a criminal prosecution more likely.

The recent successful prosecution of *Mabey & Johnson* provides further insight into the SFO's approach in this area. In its opening note in this case,[25] the SFO set down a clear marker that it would reward cooperation. More importantly, the SFO also gave some insight into what it considered cooperation to entail, stating that the preferred approach was for a company subject to allegations of corruption to conduct an internal investigation, before disclosing all of the results of that investigation (whether or not privileged) to the SFO. The SFO stated:

> Importantly, and in the spirit of exemplary and proper co-operation, the Company provided copies of privileged notes of internal interviews of certain directors and employees, conducted during the internal investigation. *As an aside, the SFO regards this approach, namely conducting an internal investigation which is then fully disclosed to the SFO as meriting specific commendation. In cases where this is not the practice of the suspect company, the SFO will not regard the co-operation as a model of corporate transparency.*[26]

Further, the SFO made the following general statement on its policy of cooperation:

> …the policy of the SFO under the present Director...is that boards of companies should be encouraged to approach the SFO and make a full disclosure of fraud or corruption they have discovered together with proposals about the changes and monitoring needed in the future to reassure the public that the behaviour of those companies meet the highest ethical standards. *If companies do this then the SFO is prepared to discuss with them the pleas or other resolution that the SFO considers to be in the public interest.*[27]

The SFO's intention to try and settle cases civilly wherever possible is vitally important to companies operating in the EU that may otherwise face the risk of a criminal conviction. Under Article 45 of the EU Public Procurement Directive (18/2004/EC),[28] companies found guilty of certain offenses, including corruption and money laundering, are automatically and perpetually barred from participating in public contracts. This bar is imposed regardless of the seriousness of the offense, and despite any mitigating factors. Concern has recently been expressed in the U.K. (including by the Secretary of State for Justice) that despite the expressed intention to settle self reported cases civilly, the strictness of the "Article 45" rules may nevertheless be prohibitive in encouraging companies to self report instances of corruption. In the field of U.K. competition law, the OFT may offer lenient treatment to businesses who report the existence of a cartel with which they are involved. Such leniency could lead to the financial penalty to which such a company would otherwise be subject being reduced, or even eliminated altogether.[29]

RECENT REGULATORY DEVELOPMENTS IN THE U.K.

There have been a number of significant developments in the U.K., which will impact the legal and enforcement regime in which internal investigations are conducted. These developments include:

- The sweeping changes to U.K. anticorruption law that have been proposed. In the Queen's speech in November 2009, the government presented to Parliament a Bribery Bill that would seek to replace the existing statutes with a single statutory regime, based around two general offenses which do not distinguish between public and private bribery: one of paying bribes, and the other of receiving them. The Bill also seeks to create two new offenses: bribery of a foreign public official and a corporate offense of failure to prevent bribery by a "commercial organization."
- Although the U.K. already sought to give effect to its obligations under the OECD Convention by virtue of the 2001 Act (discussed above), that Act simply gave extraterritorial application to the existing laws. The Bill goes further by providing for a specific new offense of bribery of a foreign public official. It is also appropriate to note that while only U.K. citizens or corporations are currently subject to the anticorruption laws, under the new Bill this is extended to individuals ordinarily resident in the U.K.
- Two main points need to be made about the new corporate offense of failure to prevent bribery: First, the Bill envisages that a company can avail itself of a defense of "adequate procedures" to prevent bribery in certain circumstances. This is expected to raise the stakes considerably in the field of corporate compliance and ethics training programmes.[30] Second, the offense applies to "commercial organizations" which is said to include foreign corporations or partnerships carrying on business in the U.K. This will make the U.K.'s corporate anticorruption laws of potentially very wide application and will now affect companies that have hitherto chosen to ignore the U.K.'s anticorruption regime.
- The SFO's guidelines on self reporting of corruption and the SFO's new enforcement approach, as evidenced by its first ever corporate bribery prosecution and conviction in the case of *Mabey & Johnson* (both discussed above).
- Proposals to give the FSA power to grant statutory immunity.[31] At present, the FSA only has power to grant immunity at common law, which is not capable of binding other prosecutors.

- Explicit attempts by Richard Alderman, the Director of the SFO, for the SFO to work more closely with their U.S. counterparts in the Department of Justice.[32]
- Pledges by both the FSA and the SFO that they will become more effective enforcers of the law proceedings.

NOTES

[1] Richard Alderman, "Talking Corruption with the SFO," October 20, 2009, Debevoise & Plimpton LLP's First Annual ICID Lecture. *Available at:* http://www.sfo.gov.uk/about-us/our-views/speeches/speeches-2009/talking-corruption-with-the-sfo.aspx.

[2] Although there is no explicit duty of directors to investigate suspicions of wrongdoing, the directors' duties of care, skill and diligence and of promoting the success of the corporation would require that a director investigate such allegations and, if necessary, report them to the appropriate regulator.

[3] Such suspicious transaction reports are required by the market abuse regime and the anti-money laundering regime, amongst others.

[4] Such an investigation was recently launched into alleged fraudulent and anticompetitive conduct on the part of JJB Sports and Sports Direct.

[5] The factors to be taking into account in making this determination are: (i) whether the value of the alleged fraud exceeds £1 million; (ii) whether there is a significant international dimension; (iii) whether the case is likely to be of widespread public concern; (iv) whether the case requires highly specialized knowledge (e.g. of financial markets); and (v) whether there is a need to use any of the SFO's special powers.

[6] The Crown Prosecution Service would be responsible for investigating and prosecuting more low level examples of fraud and corruption.

[7] In order to obtain a CRO, it is not necessary for the SFO to establish an offence against a particular company or individual. The SFO has had the power to seek such orders since April 2008, and deployed them for the first time in October 2008, when a CRO for £2.25 million was made against construction firm Balfour Beatty in respect of payment irregularities stemming from the dealings of one of its former subsidiaries in Egypt. In this case, Balfour Beatty self reported the payment irregularities to the SFO, and consented before the court to the imposition of the CRO.

[8] *See* the SFO's press release of September 25, 2009, *available at* http://www.sfo.gov.uk/press-room/latest-press-releases/press-releases-2009/mabey--johnson-ltd-sentencing-.aspx.

[9] Although the SFO is the primary investigating agency for instances of overseas corruption, the enforcement of the FSA's rules can lead to the FSA taking a role in cases involving overseas corruption, such as the fine that it imposed on Aon Ltd in January 2009 — discussed further below — for breach of the FSA's Principles for Businesses.

[10] Cooperation between the SFO and FSA is discussed in the following article: http://www.compliancereporter.com/Article.aspx?ArticleID=2270085.

[11] For details of this, see the FSA's press release on the matter, *available at* http://www.fsa.gov.uk/pages/Library/Communication/PR/2009/004.shtml.

[12] Directive 95/46/EC.

[13] These exceptions include: (i) the transfer being necessary for the performance of a contract between the data subject and the data controller; (ii) the transfer being necessary for reasons of substantial public interest, and (iii) the transfer being necessary for the purpose of, or in connection with, any legal proceedings.

[14] *Durant v. Financial Services Authority* [2003] EWCA Civ 1746.

[15] In determining whether or not data affected a person's privacy, the Court of Appeal held that two notions were of assistance: (i) whether the information is biographical in a significance sense, *i.e.* going beyond the recording of the putative data subject's involvement in a matter which has no personal connotations; and (ii) the focus of the data, *i.e.* whether or not the data had the putative data subject as its focus.

[16] Sensitive personal data is defined in the DPA as personal data consisting of information as to, (i) the racial or ethnic origin of the data subject; (ii) his political opinions; (iii) his religious or other beliefs; (iv) whether or not he is a member of a trade union; (v) his physical or mental health or condition; (vi) his sexual life; (vii) the commission or alleged commission by him of any offence; and (viii) any proceedings for any offence committed or alleged to have been committed by him, the disposal of such proceedings or the sentence of any court in such proceedings.

[17] An example of such a breach might be when an employer acts improperly in relation to personal data or confidential information (aside from the obligations under the DPA and the duty of confidentiality discussed herein).

[18] *Balabel v. Air India* [1988] 2 All ER 246, quoted with approval in *Three Rivers*

District Council and others v. Governor and Company of the Bank of England [2004] UKHL 48 ("*Three Rivers 6*"). *Three Rivers 6* involved advice given by a firm of solicitors to the Bank of England during the course of an inquiry into the Bank of England's supervision of a bank ("BCCI") which collapsed as a result of massive fraud. The House of Lords held that legal professional privilege applied not only to advice given as to the state of the law, but also to advice as to how the Bank of England might best present information to the inquiry.

[19] *Three Rivers District Council and others v. Governor and Company of the Bank of England* [2003] EWCA Civ 474 ("*Three Rivers 5*").

[20] *Three Rivers 5, ibid.*

[21] Public Interest Disclosure Act 1998, which inserted various provisions into the Employment Rights Act 1996.

[22] Section 43F Employment Rights Act 1996.

[23] Attorney General's Guidelines on plea discussions in cases of serious or complex fraud, *available at* http://www.attorneygeneral.gov.uk/Publications/Pages/AttorneyGeneralsGuidelines.aspx.

[24] *Available at:* http://www.sfo.gov.uk/bribery--corruption/self-reporting-corruption.aspx.

[25] *Available at* http://www.sfo.gov.uk/media/41953/sfo-annex2-statement-01-250909.pdf.

[26] *Ibid*. at Paragraph 26 (emphasis added).

[27] *Ibid*. at Paragraph 20 (emphasis added).

[28] As given effect in the U.K. by Regulation 23 of the Public Contracts Regulations 2006 and Regulation 26 of the Utilities Contracts Regulations 2006.

[29] *See* the OFT guidance on leniency, available at http://www.oft.gov.uk/news/press/2008/144-08.

[30] It is to be noted that when the draft Bill was first introduced to Parliament it provided for an offense of negligent failure to prevent bribery by a commercial organization. However, following representations which were made to the Joint Parliamentary Committee on the Bribery Bill, this has now been turned into a strict liability offence (subject to the adequate procedures defence).

[31] The proposal can be found in Section 71 of the Coroners and Justice Bill.

[32] The recent $579 million settlement of U.S. Foreign Corrupt Practices Act charges by Halliburton and its former subsidiary Kellogg, Brown and Root, which followed an investigation featuring close cooperation between the Department of Justice and the SFO, is an example of such cooperation at work.

Fraud and Forbearance: State Courts Divided on Whether to Recognize Claims by Securities Holders

STANLEY J. PARZEN, BRIAN J. MASSENGILL, AND DANA S. DOUGLAS

Two recent state appellate court cases demonstrate the division in the law regarding whether holders of securities can maintain a cause of action related to alleged fraud and negligent misrepresentation.

Earlier this year, the Supreme Court of Georgia issued a decision[1] that expands the availability of fraud and negligent misrepresentation claims in the securities context. The court held that Georgia common law recognizes fraud and negligent misrepresentation claims based on forbearance in the sale of publicly traded securities — commonly known as "holder" claims — if plaintiffs allege that the misrepresentations were directed at them to their injury and that plaintiffs specifically relied on those purported misrepresentations.

Three months later, on May 27, 2010, a New York appellate court reached a contrary conclusion,[2] casting doubt on the longstanding recognition of holder suits under New York law. These decisions illustrate the

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current divergence between a number of U.S. states in their approaches to these suits.

GEORGIA: THE *HOLMES v. GRUBMAN* DECISION

Plaintiff William K. Holmes alleged that on June 25, 1999, he verbally ordered his broker at Salomon Smith Barney & Co., Inc. ("SSB") to sell his WorldCom shares. According to Holmes, SSB and its financial analyst, Jack Grubman, convinced him not to sell his 2.1 million shares in WorldCom. Instead of selling, Holmes purchased additional shares of WorldCom as the stock price declined. In October 2000, Holmes was forced to sell all of his WorldCom shares to meet margin calls, resulting in substantial losses. Holmes' complaint, which originated in a Georgia bankruptcy proceeding, was dismissed[3] for failure to state a claim by the U.S. District Court for the Southern District of New York, which is handling the WorldCom multidistrict litigation. The U.S. Court of Appeals for the Second Circuit affirmed[4] the dismissal but certified three questions to the Supreme Court of Georgia:

- Does Georgia common law recognize fraud claims based on forbearance in the sale of publicly traded securities?
- With respect to a tort claim based on misrepresentations or omissions concerning publicly traded securities, is proximate cause adequately pleaded under Georgia law when a plaintiff alleges that his injury was a reasonably foreseeable result of defendant's false or misleading statements but does not allege that the truth concealed by the defendant entered the market place, thereby precipitating a drop in the price of the security?
- Under Georgia law, does a brokerage firm owe a fiduciary duty to the holder of a non-discretionary account?

The Supreme Court of Georgia answered the first question in the affirmative, stating that one of the elements for proving fraud under Georgia law is an intention to induce the plaintiff to act or refrain from acting. The Holmes court found support for its holding in both the Restatement (Sec-

ond) of Torts § 525 as well as *Blue Chip Stamps v. Manor Drug Stores*,[5] a case in which the U.S. Supreme Court held that holder claims were not available under Rule 10(b)(5) of the Securities Exchange Act of 1934, but also noted that holder claims may be available under state law. The Holmes court then set forth two limitations on such claims: direct communication and specific reliance. The "direct communication" limitation requires that plaintiffs allege that the misrepresentations were directed to them. The "specific reliance" limitation requires that plaintiffs allege actions, rather than unspoken or unrecorded thoughts and decisions, indicating that the plaintiffs actually relied on the misrepresentations.

With respect to the second question, the Holmes court rejected the argument that plaintiffs could establish proximate causation by simply alleging that injury was a "reasonably foreseeable result" of the misrepresentation. Rather, the court concluded that, with respect to a tort claim based on misrepresentations or omissions concerning publicly traded securities, plaintiffs have the burden of proving that the truth concealed by the defendant actually entered the marketplace, thereby precipitating a drop in the price of the security. The court further held that plaintiffs must show that it was this revelation of the concealed truth that caused the loss and not merely one of several factors that affected the price.

Finally, the Holmes court held that a stockbroker has fiduciary duties towards a customer who holds a non-discretionary account. After recognizing that the broker owes a number of limited duties to the client regarding the transaction of business, the court further concluded that fiduciary duties owed by a broker to a customer with a non-discretionary account are not restricted to the actual execution of transactions. In addition, the broker has a heightened duty when recommending an investment which the holder of a non-discretionary account has previously rejected or as to which the broker has a conflict of interest.

With the *Holmes* decision, Georgia joins a handful of other states that have recognized holder claims either in the state courts or in federal courts interpreting states' laws, including California, Florida, Massachusetts, New Jersey, and Wisconsin.[6]

NEW YORK: THE *STARR v. AIG* DECISION

New York has traditionally recognized fraud claims where a defendant's misrepresentations induced investors to hold securities.[7]

On May 27, 2010, however, a New York appellate court held that a plaintiff's holder claim violated the "out-of-pocket" rule governing losses recoverable for fraud. Pursuant to the out-of-pocket rule, the true measure of damages for fraud is the actual pecuniary loss sustained as the direct result of the wrong. In *Starr Foundation v. American International Group, Inc.*, Starr Foundation alleged that, but for AIG's purported misrepresentations, it would have continued to sell 15.5 million shares of AIG stock. The appellate court held that Starr Foundation's holder claim was "virtually the paradigm of the kind of claim that is barred by the out-of-pocket rule," because "a lost bargain more 'undeterminable and speculative' than this is difficult to imagine." The court determined that, in continuing to hold the AIG stock, the plaintiff did not lose or give up any value; rather, the plaintiff remained in possession of the true value of the stock, whatever that value may have been at any given time. Accordingly, Starr Foundation did not suffer any out-of-pocket loss as a result of retaining its AIG stock.

In addition to the New York appellate court, several federal courts have expressed doubt with the approach taken by Georgia and other courts, noting that claims for damages under holder claims are untenable. The District of Connecticut dismissed a holder claim on the ground that "the claims for damages based on the plaintiffs' failure to sell or hedge their stock are too speculative to be actionable."[8] Federal courts applying Mississippi, Illinois, and Virginia law have relied on similar principles of loss causation to reject holder claims, reasoning that those who hold securities during the fraud are unable to plead that the misrepresentations caused their loss.[9]

IMPLICATIONS AND CONCLUSIONS

Given the division in state law, it is clear that potential liability to holders of securities varies widely depending upon the jurisdiction in which claims are brought. The Supreme Court of Georgia was quick to point out that "induced forbearance can be the basis for tort liability" and

is consistent with the Restatement (Second) of Torts § 525. Courts that have not yet considered the availability of fraud and negligent misrepresentation claims to holders of securities also could rely on the Restatement (Second) of Torts § 525 to permit holder claims.

The recent decision in New York, however, adds to the doubt cast upon the enforceability of holder claims. Holder plaintiffs will face difficulty pleading reliance, making holder claims susceptible to a motion to dismiss.[10] If a holder claim survives a motion to dismiss, the plaintiff will have difficulty proving causation and damages. Thus, while certain states recognize holder claims, they may remain a practical impossibility due to the difficulties most plaintiffs will have proving the critical elements of misrepresentation claims.

NOTES

[1] *Holmes v. Grubman*, 691 S.E.2d 196 (Ga. 2010).

[2] *Starr Foundation v. American Intern. Group, Inc.*, 2010 WL 2104535 (N.Y.A.D. 1st Dept. May 27, 2010).

[3] *Holmes v. Grubman (In re WorldCom, Inc. Securities Litigation),* 456 F. Supp. 2d 508 (S.D.N.Y. 2006).

[4] *Holmes v. Grubman*, 568 F.3d 329 (2nd Cir. 2009).

[5] *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730-31, 738 (1975).

[6] *Small v. Fritz Companies, Inc.*, 65 P.3d 1255, 1259 (Cal. 2003) (collecting cases); *see also Rogers v. Cisco Systems, Inc.*, 268 F. Supp. 2d 1305, 1314 (N.D. Fla. 2003) (applying Florida law and recognizing "holder" claims but dismissing claims because plaintiffs' allegations of reliance were too vague); *see also Seideman v. Sheboygan Loan & Trust Co., et al.*, 223 N.W. 430, 433 (Wis. 1929).

[7] *Continental Ins. Co. v. Mercadante*, 222 App. Div. 181 (N.Y.A.D. 1st Dept. 1927).

[8] *Chanoff v. United States Surgical Corp.*, 857 F. Supp. 1011, 1018 (D. Conn. 1994) (applying Connecticut law).

[9] *See In re WorldCom, Inc. Securities Litigation*, 336 F. Supp. 2d 310, 320 (S.D.N.Y. 2004) (collecting cases).

[10] *Dloogatch v. Brincat*, 396 Ill. App. 3d 842, 849-854 (1st Dist. 2009) (collecting cases and holding that plaintiffs failed to plead reliance or damages in holder claim).

Upping the Ante for Whistleblowers: New Regulatory Reform Act Incentivizes Whistleblowers to Disclose Potential Violations of the Foreign Corrupt Practices Act to the Government

RITA GLAVIN, CRAIG MARGOLIS, AND YOUSRI OMAR

As the authors explain, the potential effects of the Dodd-Frank Act's whistleblower provisions, particularly in enforcement actions under the Foreign Corrupt Practices Act, are significant.

Among its sweeping regulatory reforms aimed at the financial industry, a little-noticed provision of the Dodd-Frank Wall Street Reform and Consumer Protection Act (H.R. 4173, or the "Act"), passed by Congress on July 15, 2010, and signed into law by President Obama on July 21, 2010, likely will have a substantial impact on public companies subject to the U.S. Foreign Corrupt Practices Act ("FCPA") by incentivizing "whistleblowers" who provide original information to the Securities and Exchange Commission (SEC) with a bounty in the event the SEC later recovers damages or penalties from the companies. While the potential bounty is not limited to FCPA cases, this whistleblower provision will open

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up yet additional avenues for the SEC and Department of Justice ("DOJ") to investigate and prosecute FCPA violations.[1] The new legislation may lead to an increase in SEC-initiated actions that would reach a host of public companies operating in many industries. So that public companies may understand and anticipate the potential impact of the new Act, we provide below a brief summary and a comparison of the whistleblower provision to a similar provision in the False Claims Act ("FCA").

Since the Civil War, the FCA has contained a provision that empowers private plaintiffs to bring *qui tam* lawsuits against individuals and companies suspected of defrauding the government, both for themselves and on behalf of the United States. In such actions, the government may choose to intervene in the case, or to allow the private plaintiff (known as a "relator") to proceed alone. Depending on a number of factors, including the importance of the relator's efforts to the success of the case, the relator may receive a percentage of the government's recovery. Because recoveries under the FCA can be substantial (usually three times the actual damages, plus the relator's expenses, plus a penalty of $5,500 to $11,000 per violation), the relator's award is a substantial inducement to come forward with information regarding potential fraudulent activity.

The new Act shares a number of features with the FCA whistleblower provision, but as explained below has a narrower reach than the FCA, and vests significant discretion in the SEC rather than the courts in whether, and to what extent, a whistleblower should share in the government's recovery. The Act requires the SEC to provide a reward to anyone who provides "original information" leading to the successful enforcement of the securities laws in a "covered judicial or administrative action" or a "related action." Whistleblowers will receive between 10 and 30 percent of the government's recovery, with the precise award to be determined by the SEC. Whistleblowers will be compensated out of a new Investor Protection Fund, established out of the proceeds of actions resolved based on whistleblower-provided information. In addition, just as in the FCA, whistleblowers may sue their employers if they are discriminated against on the basis of their lawful efforts to stop or report illegal activity. The statute requires the SEC to issue final implementing regulations within 270 days of enactment.

WHISTLEBLOWERS MAY RECOVER FOR PAST VIOLATIONS

A whistleblower providing information will be entitled to recover regardless of when the illegal conduct about which he or she reports occurred. For example, a whistleblower may recover an award based on information he or she provides in 2011, leading to a successful enforcement action for a violation of the securities laws that occurred in 2008.

WHISTLEBLOWERS CANNOT INDEPENDENTLY BRING ACTIONS

Under the new statute, the whistleblower recovers only if the government prevails on the basis of his or her information. The whistleblower cannot independently bring an action against an alleged violator of the securities laws, and may not proceed alone if the government declines to prosecute the case.

AWARDS LIMITED TO "COVERED JUDICIAL PROCEEDINGS"

Unlike the FCA, which allows actions to be brought for any false or fraudulent claim submitted to the government, whistleblowers may only recover if the government prevails in a "covered judicial proceeding," defined as any judicial or administrative action brought by the SEC resulting in monetary sanctions of over $1 million. Following such a proceeding, the whistleblower may recover a percentage of the total monetary sanctions imposed in the covered proceeding. The whistleblower may also recover in any "related action" brought by another agency, such as the DOJ, which is based on the whistleblower-provided information. This is significant in the FCPA context, as the SEC and DOJ have parallel enforcement responsibility for the FCPA and often cooperate to collectively investigate, but individually penalize, FCPA violators.

SEC HAS SIGNIFICANT DISCRETION IN GRANTING AWARDS

Under the FCA, while the bounds of the relator's award are defined by statute, courts have some discretion as to the precise amount. The

new provision also defines the maximum and minimum award, but the SEC has discretion as to the ultimate amount. In setting the amount of any whistleblower recovery, the SEC will consider the importance of the whistleblower's information, the degree of assistance the whistleblower or his counsel provided, and the SEC's "programmatic interest" in deterring violations, as well as additional factors to be included in implementing regulations. Unlike the FCA, the provision makes no explicit mention of awards upon the government's successful settlement of a case, but does reference paying awards based on successful enforcement, which may include settlements. In addition, the new Act excludes broad classes of individuals from recovery on the basis of their criminal activity, government employment, or duties to disclose under federal securities laws.

DIFFERENT "ORIGINALITY" REQUIREMENTS

Under both the new Act and the FCA, rewards are usually not available if the information provided is already publicly available, but the specific requirements of the two statutes differ. The FCA prevents courts from hearing cases based on information disclosed in public proceedings or in the media, unless the relator is the "original source" of the information. The relator is the "original source" only if, prior to a public disclosure, he or she voluntarily disclosed the information, or had knowledge independent of the publicly disclosed information that materially added to the public allegations *and* voluntarily provided this information to the government before filing a lawsuit.

By contrast, the new provision allows for rewards if the government prevails on the basis of the whistleblower's "original information." This is defined as information that is derived from his or her independent knowledge or analysis and not known to the SEC from any other source (unless the whistleblower is the original source), and is not derived exclusively from an allegation made in a government proceeding or in the news media, unless the whistleblower is a source of the information. Unlike the FCA, the statute does not define original source.

REPRESENTATION BY COUNSEL

The new provision allows whistleblowers to be represented by counsel, and in particular, to recover on the basis of anonymous claims made through their attorneys, so long as the attorney discloses the whistleblower's identity before the award is paid.

CONFIDENTIALITY OF WHISTLEBLOWER-PROVIDED INFORMATION

The new provision empowers the government to keep whistleblower-provided information confidential. Information provided by whistleblowers is exempt from Freedom of Information Act requests, civil discovery requests, and other legal process, and is considered privileged and confidential; however, it can be disclosed to other governmental bodies when "necessary to protect investors."

JUDICIAL REVIEW OF WHISTLEBLOWER AWARDS

Whistleblower awards made under the new statute may be appealed to a federal circuit court, and are reviewed in the same manner as other agency actions.

The potential effects of the legislation, particularly in FCPA enforcement, are significant. Over the past decade, the SEC and the DOJ have made prosecution of FCPA violations a top priority. The level of FCPA enforcement and settlements has reached an all time high, with recent settlement amounts upwards of $500 million. The new Act's whistleblower provision is likely to spark an even greater number of investigations by incenting individuals employed by companies subject to the FCPA to report potential violations directly to the SEC. In addition to the increased risk for scrutiny and investigation, companies subject to the FCPA could find that by incenting direct disclosure by individuals, the Act's whistleblower provision undermines their ability to conduct an internal review and evaluation of any potential violation before disclosing the issue to the government.

NOTE

[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, § 922 *et seq.* (2010).

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