Saul Ewing LLP

WHITE COLLAR AND GOVERNMENT ENFORCEMENT PRACTICE

JANUARY 2012

White Collar Watch

The Newsletter of the White Collar and Government Enforcement Practice

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CONTENTS

Prosecutorial misconduct in FCPA case results in dismissal of indictment
pages 1 - 2

Court challenges SEC practice of settling cases without defendants admitting or denying allegations
pages 3 - 4

New Jersey State Commission of Investigation takes aim at solid waste and recycling industries and recommends overhaul of A-901 Program
pages 5 - 6

Prosecutorial misconduct in FCPA case results in dismissal of indictment

By Christopher R. Hall and Charles T. Williams, III

We have recently written (*White Collar Watch* September 2011) about the uptick in prosecutions under the Foreign Corrupt Practices Act, 15 U.S.C. §§ 78dd-1, *et seq.* (the "FCPA"), which prohibits, among other things, bribery of foreign officials for commercial advantage. A recent case, *United States v. Aguilar,* is an example of a case in which the government's overzealous prosecution under the FCPA involved "flagrant" misconduct that necessitated a dismissal of the indictment against a corporate defendant and two of its officers. This case is not only a cautionary tale for the government, but also a reminder to defense counsel of the importance of building a record that may later form the basis for the dismissal of an indictment or the reversal of a conviction.

LINDSEY MANUFACTURING CO. (UNITED STATES v. AGUILAR)

In early September 2010, Enrique Aguilar and his wife, Angela Aguilar, were charged with multiple violations of the FCPA. About a month after indicting the Aguilars, the government added Lindsey Manufacturing Company ("Lindsey"), as well as Keith E. Lindsey, its President and CEO, and Steve K. Lee, its Vice President and CFO (the "Lindsey Defendants") as defendants under the indictment, charging them with, among other things, conspiracy and substantive violations of the FCPA.

This gist of the government's case was that the Lindsey Defendants bribed certain high-ranking officials of La Comisión Federal de Electricidad ("CFE"), an electric utility company that is wholly-owned by the Mexican government, and also one of Lindsey's largest customers. The government alleged that the Lindsey Defendants funneled bribes to the CFE officials through a company called El Grupo Internacional de Asesores S.A. ("Grupo"), that was controlled by the Aguilars. The government alleged that, although certain Lindsey officers knew that Enrique Aguilar was under investigation in Mexico for corruption, it nevertheless paid Grupo a "sales commission" of 30 percent of the revenues Lindsey generated from CFE contracts that it earned after it hired Enrique Aguilar. The sales commissions paid to Grupo were alleged to be higher than the industry standard, and higher than any other commission paid by Lindsey to any of its other sales representatives. The government further alleged that these sales commissions ostensibly were used to bribe the CFE officials and to purchase certain luxury goods (both for themselves and for the CFE officials).

The record illustrates a severely flawed investigation and prosecution. For example, one of the prosecutors in the *Aguilar* case was also the lead prosecutor in an earlier case, *United States v. O'Shea* (see *White Collar Watch* September 2011), in which it was alleged that payments made to an entity called Sorvill, also controlled by the Aguilars, were used to bribe CFE officials on behalf of a company called ABB, Inc. During the trial against the Lindsey Defendants, the government pushed aggressively to link Sorvill to the Lindsey Defendants, but the court held that there was no evidence the Lindsey Defendants had ever heard of Sorvill. In addition to its attempt to manufacture a link between the Lindsey Defendants and Sorvill (and thus impute the alleged conduct in that case to the Lindsey Defendants in this case), the prosecutors engaged in "flagrant" misconduct both before and after the Lindsey Defendants were indicted, including:

- Submitting an affidavit of an investigating FBI agent that contained false and misleading statements, which later formed the basis for search warrants executed against the Lindsey Defendants;
- Obtaining communications between the Aguilars that exceeded the scope of the applicable warrant, with the intent of using the information obtained to implicate the Lindsey Defendants;
- Exceeding the scope of a search warrant by searching buildings not included within the warrant;
- Obtaining a statement from defendant Keith Lindsey without giving proper *Miranda* warnings;
- Allowing an FBI agent to give false or misleading testimony to the grand jury, which ultimately led to the indictment of the Lindsey Defendants;
- Failing to turn over potentially exculpatory evidence (e.g., transcripts of certain grand jury testimony, interview notes with potentially exculpatory witnesses, etc.) when properly requested by the Lindsey Defendants (in violation of the standard articulated in *Brady v. Maryland* and its progeny);
- Violating the court's trial instructions and orders on multiple occasions.

On May 9, 2011, before the jury began its deliberations, the Lindsey Defendants filed a motion to dismiss based on governmental misconduct. After a five week trial, but before the court decided the Lindsay Defendants' motion to dismiss, the jury returned its verdict and convicted the Lindsey Defendants on all counts.

In late 2011, the court heard argument on the Lindsey Defendants' motion to dismiss. On December 1, 2011, the court issued an opinion by which it vacated the convictions and dismissed the indictment against all of the Lindsey Defendants, holding that the "multiple acts of misconduct…undoubtedly affected the verdicts and thus substantially prejudiced the Lindsey Defendants." In dismissing the indictment with prejudice, the court expressed its hope that its ruling would have a "valuable prophylactic effect."

THE TAKE AWAY

The *Aguilar* case is a cautionary tale for the government to guard against sloppy investigations and flagrant misconduct in pursuit of a conviction. Indeed, the court noted that the "prosecutor's job isn't just to win, but to win fairly, staying well within the rules." Here, the investigators and the prosecution went well beyond the rules, and as a result undermined the confidence in the outcome of the trial. This case is also a good reminder for defense counsel of the importance of building the pre-trial and trial record that may later form the basis for an acquittal or reversal of a conviction. The court specifically noted that it was not any one instance of misconduct, but rather the "wide range" of misconduct throughout the case that necessitated dismissal of the indictment. Defense counsel was diligent in seeking evidence at each stage of the case, and was relentless in pursuing that information when the government failed to comply fully with the court's rulings. While this case highlights particularly egregious prosecutorial misconduct that certainly is not present in most cases, it nevertheless shows that where defense counsel can establish a wide range of misconduct that spans an entire case, it may be able to show that the "drastic step" of dismissing the indictment is appropriate. At the very least, as prosecutions under the FCPA increase and the limited precedent under the statute continues to evolve, *Aguilar* will be on the minds of both the prosecution and the defense.

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Court challenges SEC practice of settling cases without defendants admitting or denying allegations

By Nicholas J. Nastasi and Justin B. Ettelson

On November 28, 2011, Judge Jed S. Rakoff of the United States District Court for the Southern District of New York issued an order rejecting the proposed $285 million settlement of the Securities and Exchange Commission's ("SEC") lawsuit against Citigroup Global Markets, Inc. ("Citigroup") wherein the SEC alleged that Citigroup "misle[d] investors about a $1 billion collateralized debt obligation tied to the U.S. housing market in which Citigroup bet against investors as the housing market showed signs of distress." The proposed settlement consisted of $160 million of disgorged profits, $30 million in prejudgment interest, and a $95 million civil penalty, all of which the SEC proposed would be returned to harmed investors. In rejecting the settlement, Judge Rakoff noted the "long hours trying to determine whether, in view of the substantial deference due the SEC, the Court [could] somehow approve [the] problematic Consent Judgment." Ultimately, the Court concluded that it could not "because the Court ha[d] not been provided with any proven or admitted facts upon which to exercise even a modest degree of independent judgment." The Court set a trial date of July 16, 2012.

Judge Rakoff's ruling puts into question what has long been the SEC's practice of settling cases without defendants admitting or denying allegations, a practice employed to settle, among other cases, those related to the collapse of the housing market, including: a $550 million settlement with Goldman, Sachs & Co. ("Goldman") involving allegations that Goldman "misled investors in a subprime mortgage product just as the U.S. housing market was starting to collapse;" a $153.6 million settlement with J.P. Morgan Securities LLC ("J.P. Morgan") involving allegations that J.P. Morgan "misled investors in a complex mortgage securities transaction just as the housing market was starting to plummet;" and an $11 million settlement with Wells Fargo Securities LLC ("Wells Fargo") involving allegations that Wells Fargo "engaged in misconduct in the sale of two collateralized debt obligations tied to the performance of residential mortgage-backed securities as the housing market show[ed] signs of distress in late 2006 and early 2007."

On December 15, 2011, the SEC's Director of the Division of Enforcement, Robert Khuzami, released a statement in which he said that, "In deciding whether to settle, the SEC considers, among other things, limitations under the securities laws" and whether "the applicable statute…[entitles] the SEC to recover the amount lost by investors." Moreover, said Khuzami, the SEC takes the position that "a settlement puts money back in the pockets of harmed investors without courtroom delay and without the twin risks of losing a trial or winning but recovering less than the settlement amount" and "does not limit the ability of injured investors to pursue claims for additional relief." Of the SEC's settlement practice, Judge Rakoff commented "that a consent judgment that does not involve any admission and that results in only very modest penalties is…viewed, particularly in the business community, as a cost of doing business imposed by having to maintain a working relationship with a regulatory agency, rather than as any indication of where the real truth lies."

In the present case, the SEC alleged that "Citigroup structured and marketed a CDO called Class V Funding III [(the "Fund")] and exercised significant influence over the selection of $500 million of the assets in the CDO portfolio…then took a proprietary short position against those mortgage related assets from which it would profit if the assets declined in value." Citigroup was charged by the SEC with negligence in violation of Sections 17(a)(2) and (3) of the Securities Act of 1933. The SEC alleged that Citigroup made $160 million in fees and trading profits while investors suffered losses of more than $700 million. In its Memorandum of Law in support of the proposed settlement, the SEC argued that, "The proposed consent judgment…is fair, adequate, and reasonable…and is the product of arm's-length negotiations between sophisticated parties and is therefore entitled to a presumption of reasonableness."

In his order, Judge Rakoff took particular issue with the fact that the SEC, in its original Memorandum in support of the proposed Consent Judgment, "endorsed the standard of review of 'whether

the proposed Consent Judgment…is fair, reasonable, adequate, and in the public interest.'" However, in its Memorandum of Law in response to specific questions raised by the Court, the SEC argued that, "while the Consent Judgment must still be shown to be fair, adequate, and reasonable, 'the public interest…is not part of the applicable standard of judicial review.'" The Court reasoned that "the requirement that a consent judgment be in the public interest is not meaningfully severable from the requirements…that the consent judgment be fair, reasonable, and adequate…and that the settlement…be fair 'to the parties and to the public.'" Consequently, the Court held "that the proposed Consent Judgment is neither fair, nor reasonable, nor adequate, nor in the public interest…because it does not provide the Court with a sufficient evidentiary basis to know whether the requested relief is justified under any…standards."

The Court was also troubled by the SEC's position "that, because Citigroup did not expressly deny the allegations, the court, and the public, somehow knew the truth of the allegations." In the Court's mind, an allegation "that is neither admitted nor denied" remains an allegation and "has no evidentiary value and no collateral estoppel effect." Consequently, "consent judgments…can not be used as evidence in subsequent litigation." Therefore, the benefit to Citigroup to settle the case "is that it avoids any investors' relying in any respect on the SEC Consent Judgment in seeking return of their losses. If the allegations…are true, this is a very good deal for Citigroup; and, even if they are untrue, it is a mild cost of doing business." The Court found that the only benefit to the SEC was "a quick headline." The Court concluded by holding that:

> a proposed Consent Judgment that asks the Court to impose substantial injunctive relief, enforced by the Court's own contempt power, on the basis of allegations unsupported by any proven or acknowledged facts whatsoever, is neither reasonable, nor fair, nor adequate, nor in the public interest. It is not reasonable, because how can it ever be reasonable to impose substantial relief on the basis of mere allegation? It is not fair, because, despite Citigroup's nominal consent, the potential for abuse in imposing penalties on the basis of facts that are neither proven nor acknowledged is patent. It is not adequate, because, in the absence of facts, the Court lacks a framework for determining adequacy. And, most obviously, the proposed Consent Judgment does not serve the public interest, because it asks the Court to employ its power and assert its authority when it does not know the facts.

On December 15, 2011, the SEC filed an appeal of Judge Rakoff's ruling because it believes that the Court "committed legal error by announcing a new and unprecedented standard that inadvertently harms investors by depriving them of substantial, certain and immediate benefits." The SEC is of the position that such a standard "could in practical terms press the SEC to trial in many more instances, likely resulting in fewer cases overall and less money being returned to investors." To that end, SEC Chair Mary Schapiro testified to Congress on December 6, 2011, that, "If the SEC does not receive additional resources, many of the issues highlighted by the financial crisis and which the Dodd-Frank Act seeks to fix will not be adequately addressed, as the SEC will not be able to build out the technology and hire the industry experts and other staff desperately needed to oversee and police these new areas of responsibility." Citigroup filed an identical appeal notice on December 19, 2011.

Signaling an apparent shift, albeit limited in scope, in its settlement policy, Khuzami announced on January 6, 2012, that the SEC will no longer settle civil cases without companies admitting or denying the charges when the company admits wrongdoing in a parallel criminal case. According to the SEC, the policy change came "[f]ollowing a review by senior enforcement staff that began [last] spring and…is separate from and unrelated to the recent ruling in the Citigroup case, which does not involve a criminal conviction or admissions of criminal law violations." Said Khuzami, "It…seemed unnecessary for there to be a 'neither admit' provision in those cases where a defendant had been criminally convicted of conduct that formed the basis of a parallel civil enforcement proceeding." In another development, the SEC sought and won on December 17, 2011, a ruling from the Second Circuit Court of Appeals for a temporary stay of the Citigroup case – apparently moments before Judge Rakoff issued a ruling denying the stay on the same date. Motions concerning whether to continue the stay were due to a panel of the Appeals Court on January 17, 2012. We will continue to monitor developments in this case.

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New Jersey State Commission of Investigation takes aim at solid waste and recycling industries and recommends overhaul of A-901 Program

By David C. Apy

Citing 30 examples of organized crime infiltration, New Jersey's State Commission of Investigation recently released a sweeping report alleging severe deficiencies in the state's Solid Waste Licensing (A-901) Program and recommending changes designed to broaden its scope in an effort to combat corruption in the solid waste and recycling industries. While the intent of the proposed changes is laudable, they will inevitably make the already cumbersome process of obtaining and maintaining a license even more so for legitimate business concerns.

"The State Commission of Investigation, which first uncovered significant criminal intrusion into solid waste as far back as the late 1960s, has found that the industry today remains open to manipulation and abuse by criminal elements that circumvent the State's existing regulatory and oversight system" by hiding behind seemingly legitimate businesses. According to the Commission, "Of particular concern is the vulnerability to corruption of certain activities, such as the recycling and disposal of contaminated soil and demolition debris that pose serious potential environmental and public health consequences."

After providing examples of failings of the A-901 Program to prevent criminal infiltration into the solid waste and recycling industries due to a flawed regulatory structure and inadequate funding of the A-901 Program, the Commission has recommended seven specific changes to provide "for greater scrutiny of individuals who are engaged, whether directly or indirectly, in the State's solid waste" and recycling industries.

1. **Strengthen and Expand Solid Waste Licensing Requirements**
   "The statutory underpinning of New Jersey's solid waste licensing program, the A-901 Law should be amended to require that a wider circle of individuals and entities who participate in the State's solid waste industry be subject to scrutiny prior to any action bearing upon the issuance and/or retention of a license."

2. **Require Licensing for Individuals and Businesses Engaged in Recycling**
   "Licensing requirements applicable to participants in New Jersey's solid waste collection and disposal industry – i.e., garbage carting – should be extended to cover those engaged in all forms of recycling as well."

3. **Restructure and Enhance Funding for Stronger Enforcement**
   Provide the Office of the Attorney General "with sufficient resources to do the job effectively, and a primary means to that end lies in collecting full reimbursement for the expense for background integrity checks."

4. **Prohibit Debarred Individuals, Convicted Felons and Others of Questionable Character from Holding an Indirect, Non-Licensed Stake in the Industry**
   Provide "a broad and explicit definition of what constitutes an indirect 'beneficial interest' in a licensed solid waste and/or recycling entity. The holder of that interest would then be subject to all proper and appropriate disclosure and background integrity-check requirements."

5. **Centralize and Streamline State Oversight and Enforcement**
   Responsibility for all A-901 licensing matters should be "consolidated within the Office of the Attorney General and administered by one leadership team with a dedicated in-house staff of attorneys, investigators and personnel knowledgeable about solid waste management and recycling."

6. **Require Effective Sharing of Information with Neighboring Jurisdictions**
   A "system of solid waste 'information reciprocity' should become uniform among all jurisdictions throughout the region, patterned after post-9/11 homeland security intelligence- and information-sharing protocols."

7. Centralize Debarment Lists

"[R]ules should be established to ensure that debarment information is forwarded to the Treasurer for inclusion in the central debarment list so that the status of persons and businesses deemed unfit to work under one agency's purview is made known across-the-board."

Saul Ewing LLP will continue to monitor all responses to the Commission's sweeping report, including any administrative and legislative actions designed to broaden and strengthen the A-901 Program.

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