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## Government Manipulation of Regulatory and Criminal Investigations: A New Judicial Willingness to Scrutinize

By David Gourevitch and Richard M. Gelb

In the past, challenges to the government's use of parallel proceedings have met with little success. That trend appears to be changing, with two courts dismissing federal criminal charges based on the government's abuse of simultaneous investigations. The decisions are remarkable because they challenge the disturbing but frequent practice of prosecutors' use of regulatory investigations, especially by the Securities and Exchange Commission (SEC), as stalking horses to gather evidence for the criminal investigation.

The government recognizes that witnesses are less cooperative and more likely to invoke their constitutional rights if they become aware of a criminal investigation. Thus, the SEC and Justice Department agree that the SEC will take the lead in the investigation and turn over to the prosecutors whatever documents and testimony it obtains, while the prosecutors remain in the background. The goal is to lull targets into believing that they are dealing only with a regulatory investigation by concealing the far more serious threat posed by the criminal investigation.

Traditionally, the judiciary has given the government wide latitude in conducting simultaneous investigations, leaving the line between regulatory and criminal investigations blurred and murky. However, in *United States v. Stringer*, a federal court in Portland, Oregon, recently viewed this strategy as misconduct "so grossly shocking and so outrageous as to violate the universal sense of justice."<sup>1</sup> In *United States v. Scrusby*, an Alabama federal court dismissed perjury charges against HealthSouth's CEO because of strikingly similar misconduct, concluding that the Justice Department and the SEC had "manipulated" simultaneous regulatory and criminal investigations to the defendant's detriment.<sup>2</sup>

These back-to-back decisions—along with a third rejecting the SEC's efforts to freeze Scrusby's assets because the government "undoubtedly manipulated simultaneous criminal and civil proceedings"<sup>3</sup>—may signal a new judicial willingness to scrutinize whether the government has gone too far in using parallel investigations to gain tactical advantage. This is a departure from the hands-off approach that courts historically have taken when defendants complained about government abuse of simultaneous civil/criminal investigations.<sup>4</sup>

### Parallel Investigations

Courts have long permitted the government to conduct parallel investigations. In *United States v. Kordel*, a criminal FDA case, the Supreme Court affirmed simultaneous civil and criminal investigations and information sharing, reasoning that it would stultify enforcement of federal law if the government were required to choose between pursuing civil relief or a criminal proceeding.<sup>5</sup> But the Court also cautioned that *Kordel* did not involve a "fail[ure] to advise the defendant in its civil proceeding that it contemplates his criminal prosecution" or a regulatory investigation brought "solely to obtain evidence for its criminal prosecution," suggesting that these tactics violated due process and departed from "the proper standards for the administration of justice." Despite the warning, subsequent decisions have granted the government considerable deference in the conduct of these investigations.

In the seminal securities case, *SEC v. Dresser Industries*,<sup>6</sup> the D.C. Circuit applied *Kordel* to a securities fraud investigation. The SEC and Justice Department conducted simultaneous investigations into Foreign Corrupt Practices Act violations at Dresser Industries. The SEC detailed two agents to the Justice Department to assist the criminal investigation. At the same time, the SEC turned over to the Justice Department documents and testimony that it obtained during its investigation. Dresser moved to quash an SEC document subpoena on the grounds that the SEC was likely to turn over the documents to the Justice Department, improperly broadening the scope of criminal discovery. The en banc panel held that this information sharing did not circumvent the limits of criminal discovery because those rules did not apply until after indictment. It also found that the federal securities laws encouraged cooperation and sharing between regulatory and criminal investigations.

Relying on *Dresser*, the SEC now commonly shares documents and testimony it obtains in its investigations with state and federal prosecutors. Indeed, the SEC's Form 1662, which the Enforcement Division attaches to subpoenas, contains a list of "routine uses" of information obtained in its investigation. The "routine uses" listed include a proviso that the SEC often makes its files available to other government agencies, particularly the Department of Justice.

## The *Stringer* Decision

In *United States v. Stringer*, the SEC and U.S. Attorney's Office in Oregon opened simultaneous accounting fraud investigations of FLIR Systems, Inc.<sup>7</sup> However, the SEC and U.S. Attorney's Office quickly decided that the criminal investigation would remain out of sight in order—as an FBI agent put it—“not to jeopardize the opportunity [for the SEC] to obtain statements” from the targets of the investigation. If the targets learned of the criminal investigation, the prosecutors concluded that it would “impede” the SEC's ability to obtain testimony. Indeed, the SEC went so far as to make sure that court reporters did not reveal the criminal investigation and asked Assistant U.S. Attorneys to stay away from SEC witness interviews because FLIR Systems's counsel might be present and the AUSA's presence might tip them off to the existence of a criminal investigation.

The U.S. Attorney's Office also told the SEC that it wanted to bring a perjury case based on anticipated false testimony to the SEC, instructed the SEC how to create “the best record possible” for a perjury charge, and requested that the SEC conduct its interviews in Oregon, even though doing so was inconvenient for the SEC, to ensure that venue for the hoped-for perjury charge lay within the Oregon U.S. Attorney's Office's jurisdiction.

On January 9, 2006, in a sharply worded rebuke, Judge Haggerty dismissed the 50-count indictment against the former CEO and CFO of FLIR. Judge Haggerty found that the U.S. Attorney's Office had elected to gather information through the SEC out of “concern that the presence of a criminal investigation would halt the successful discovery by the SEC, witnesses would be less cooperative and more likely to invoke their constitutional rights and the rules of criminal discovery would be invoked.” In its effort to conceal the criminal investigation, the government had engaged in “deceit and trickery.” The misconduct, which spanned several years, was “so shocking and so outrageous as to violate the universal sense of justice.”

“A government agency may not develop a criminal investigation under the auspices of a civil investigation,” Judge Haggerty wrote. “Here, . . . [t]he government's tactic to move forward under the guise of a civil investigation violated [the] defendant's due process rights.” The government's efforts to “deliberately deceive or even lull” the defendants into incriminating themselves in the SEC investigation for the benefit of the criminal investigation was inconsistent with “the administration of justice.”<sup>8</sup>

Judge Haggerty harshly criticized the SEC's long-standing policy of refusing to answer questions from defense counsel about whether there is a parallel criminal investigation. Instead, the Commission's policy is to direct counsel to the SEC's boilerplate Form 1662, which vaguely warns that criminal investigations are always a possibility. The court branded this response, which has been part of the SEC's official script for years, as “evasive and misleading” given the “close association” between the [SEC and U.S. Attorney's Office] during the [FLIR] investigation.”

In light of the *Stringer* decision, defense counsel should make sure to ask the SEC on the record whether there is a criminal investigation, and the SEC, in turn, will have to reevaluate its stock response when it knows of an ongoing criminal investigation and especially where it is working hand-in-glove with prosecutors.<sup>9</sup>

## The *HealthSouth* Decisions

The SEC and Department of Justice pursued a virtually identical strategy in the *HealthSouth* case. Two days before the SEC was scheduled to depose the company's chief executive officer, Richard Scrusby, the U.S. Attorney's Office in Birmingham, Alabama, which spearheaded the criminal investigation, telephoned the SEC and requested that the testimony be moved from Atlanta to Birmingham so that any possible perjury charge could be brought in Birmingham. “If [Mr. Scrusby] lies, then he will be lying in our district,” the AUSA explained.<sup>10</sup>

Besides changing the location of the deposition to gain a tactical advantage in a criminal case, the U.S. Attorney's Office also instructed the SEC to tailor its questions to keep Scrusby and his attorneys in the dark about the criminal investigation. The U.S. Attorney's Office declared off limits questions about HealthSouth's income statements and specific line items on its balance sheets. On the other hand, the U.S. Attorney's Office encouraged the SEC to ask questions about other areas using information that it obtained from the criminal investigation—areas that ultimately led to the perjury charges. The U.S. Attorney's Office also asked an SEC accountant to assist the criminal authorities in debriefing cooperating defendants because of his knowledge of complex accounting issues.

The activities of the U.S. Attorney's Office and SEC led Judge Bowdre to conclude that the U.S. Attorney's Office had recruited the SEC into the criminal investigation and that the two investigations had effectively merged and become inescapably intertwined unbeknownst to Scrusby who believed he was dealing only with the SEC. “To be parallel,” Judge Bowdre observed, “the separate investigations should be like the side-by-side train tracks that never intersect,” in contrast to the intertwined investigations in *Scrusby*. By using the SEC to gather evidence for the criminal investigation and by moving the deposition to benefit the criminal authorities, “the Government manipulated the simultaneous investigators for its own purposes,” which “cannot be said to be in keeping with the proper administration of justice.”

This was the second time the government had been caught manipulating the SEC and criminal investigations of HealthSouth. At a hearing on the SEC's efforts to freeze Scrusby's assets, the SEC based its case on evidence gathered by the FBI in the course of its criminal investigation, while the Justice Department simultaneously blocked Scrusby from obtaining discovery about that evidence, citing the need to maintain the secrecy of the criminal investigation. For example, the SEC tried to use a tape of a conversation that the FBI secretly recorded between Scrusby and his former comptroller. When the court directed the SEC to make the recording

available to Scrusby, the SEC lawyer balked, saying that the recording belonged to the FBI and "It's not mine to give, that's the bottom line." Similarly, the SEC introduced plea colloquies of former HealthSouth employees cooperating with the FBI, while the same employees—with at least the tacit approval of the prosecutors—invoked their Fifth Amendment privilege and refused to testify.

In a lengthy decision denying the freeze, the court held that "[T]his is a case where the government has undoubtedly manipulated simultaneous criminal and civil proceedings, both of which it controls," creating "a special danger that the government can effectively undermine rights that would exist in a criminal investigation by conducting a de facto criminal investigation using a nominally civil means. In that special situation, the risk to individuals' constitutional rights is arguably magnified."

Because of the inherent unfairness in the government's double-teaming Scrusby in this fashion, and because the SEC had not met its burden of proof, the court denied the SEC's motion to continue the asset freeze.

## Discovery

These three decisions highlight the importance of defense discovery into the government's use and abuse of simultaneous investigations. The government's manipulations in *Stringer* and *Scrusby* would not have to come to light but for the evidentiary hearings and discovery that the courts permitted. In *Scrusby*, for example, government counsel assured the court and defense counsel that Scrusby's deposition had been moved from Atlanta to Birmingham solely at Scrusby's request. The next day, however, the court discovered that, "[those] representations proved false" after an SEC accountant testified that the deposition, in fact, had been moved at the prosecutor's request and that he misled Scrusby's counsel into mistakenly believing that it had been moved at their request.

Although they have been cautious about doing so, courts have clear authority to permit discovery in aid of a motion to quash an SEC subpoena. In *Dresser*, the en banc panel of the D.C. Circuit held that discovery should be permitted where "the respondent is able to distinguish himself from the class of the ordinary respondent by citing special circumstances that raise doubts about the agency's good faith." White collar defense attorneys should seek discovery about prosecutors' use of regulatory investigations as stalking horses for criminal investigations. Attorneys representing clients that are the subjects of investigations should carefully scrutinize the activities of the SEC and U.S. Attorney's Office, including conducting discovery, to ensure that the proceedings remain parallel but separate so that informed decisions are made as to the assertion of the Fifth Amendment and other constitutional rights are protected. \*

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1. *United States v. Stringer*, 408 F. Supp. 2d 1083 (D. Or. 2006).
2. *United States v. Scrusby*, 366 F. Supp. 2d 1134, 1140 (N.D. Ala. 2005).
3. *See SEC v. HealthSouth Corp.*, 261 F. Supp. 2d 1298, 1326 (N.D. Ala. 2003).
4. *See Peter Lattman & Kara Scannell, Slapping Down a Dynamic Duo*, WALL ST. J., Jan. 25, 2006, at C1.
5. *United States v. Kordel*, 397 U.S. 1, 11 (1970).
6. *S.E.C. v. Dresser Indus.*, 628 F.2d 1368 (D.C. Cir. 1980).
7. The government alleged that the chief executive officer of FLIR Systems, Inc., J. Kenneth Stringer, and his chief financial officer, J. Mark Samper, inflated FLIR's revenue to hit earnings targets.
8. *Id.* at \*15-16. In *United States v. Parrott*, 248 F. Supp. 196 (D.D.C. 1965), the U.S. Attorney's Office waited until the conclusion of the SEC's administrative case to bring an indictment. The SEC advised the defendants before they testified in the civil case that they were not targets of a criminal investigation. At the same time, an Assistant U.S. Attorney attended the administrative proceeding and watched the defendants' testimonies. The SEC refused to disclose its identity when asked by opposing counsel during the proceeding. The court concluded that using a civil case to discover evidence for a criminal proceeding was impermissible and that the criminal authority's delay in bringing the criminal case prejudiced the defendants because witnesses had died in the interim. Along similar lines, in *United States v. Rand*, 308 F. Supp. 1231 (N.D. Ohio 1970), the court dismissed the indictment because of the government's failure to alert the defendants to the criminal investigation.
9. As an alternative ground for dismissal, Judge Haggerty found that the government "took unfair advantage" of a conflict of interest that developed between counsel for the CFO and FLIR. *Stringer*, at \*24. The same law firm represented both during the SEC investigation and represented the company alone during the criminal investigation. While he waived the conflict for the initial stages of the SEC investigation, the CFO was unaware when he did so that the investigation was gathering evidence for the U.S. Attorney's Office. "The government was the only party involved who knew the degree of the conflict" in having a single law firm represent the corporation and the CFO. *Id.* By failing to disclose it, the government "took unfair advantage of [the law firm's] conflict of interest," which Judge Haggerty found "egregious." *Id.*, at \*26.
10. *Scrusby*, at 1136. The AUSA also instructed the SEC to wait for Scrusby's attorneys to renew their request to move the deposition to Birmingham because the U.S. Attorney's Office did not want to let "them" know that the government knew about the fraud. *Id.*, at 1135. The U.S. Attorney's Office later falsely informed the court that the deposition had been moved to Birmingham at the request of Scrusby's attorneys and not because of a request from the U.S. Attorney's Office. The court and defense learned for the first time that the SEC had moved the testimony at the U.S. Attorney's Office's request during the testimony of the SEC accountant who took Scrusby's testimony.