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White Collar and Government Enforcement Practice

White Collar Watch

The Newsletter of the White Collar and Government Enforcement Practice

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Death and Taxes? Recent Supreme Court Arguments in *Gabelli v. SEC* Concerning a General Statute of Limitations for Civil Fines May Also Affect How Long the IRS Has to Assess Penalties

By Christopher R. Hall and Brian P. Simons

On January 8, the Supreme Court of the United States heard oral arguments in *Gabelli v. S.E.C.*, 133 S. Ct. 97 (2012) on the question: By when must the government initiate an action to enforce a civil fine, penalty, or forfeiture? The tenor of the arguments was heated — with Justices across the ideological spectrum taking issue with the position of the U.S. Securities and Exchange Commission ("SEC") that governmental agencies may seek to enforce civil penalties without regard to how much time has elapsed between the allegedly wrongful conduct and the commencement of the enforcement action. The Court appears poised to give greater weight to the fairness of repose than to the government's need for time to investigate after the discovery of fraud. It is also entirely possible that the High Court will reach beyond SEC enforcement actions to collar the time within which government agencies of all stripes must begin actions to assess civil penalties. This possible extension of *Gabelli* may be of particular interest to individuals and companies facing possible scrutiny from the Internal Revenue Service ("IRS"). A handful of Circuits have previously unhinged the Service's enforcement actions for fraud under 26 U.S.C. §§ 6700 and 6701 from any time constraints, and that rule of law may now come under fire.

The *Gabelli* oral argument centered around a general statute of limitations that applies to civil government actions to enforce statutes that do not specify a period of repose. Title 28, U.S.C. § 2462 provides that "an action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise, shall not be entertained unless commenced within five years from the date when the claim first accrued." In *Gabelli,* the SEC brought a civil action against Marc Gabelli, the portfolio manager for the Gabelli Global Growth Fund ("GGGF"), a mutual fund, and Bruce Albert, chief operating officer of Gabelli Funds (an investment adviser to GGGF). The SEC sought to enforce alleged violations of the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940 more than five years after an alleged

market timing scheme had ended but less than five years after the scheme was discovered. The SEC maintained that because the allegations sounded in fraud, the government's claims did not "accrue" until the government discovered the violations. While the Second Circuit agreed with this position, the Supreme Court indicated last week that it will likely not.

At argument, Chief Justice Roberts noted that while private litigants may get the benefit of the discovery rule in fraud cases, "it's when it's the sovereign that's bringing the action that the concerns about repose are particularly presented." Oral Arguments, *Gabelli v. S.E.C.*, No. 11-1274 at 47 (U.S. Jan. 8, 2013) [http://www.supremecourt.gov/oral_arguments/argument_transcripts/11-1274.pdf]. Justice Scalia expressed concern that the government's position was akin to a "no statute of limitations" rule. Justice Breyer commented that the government's position would "effectively abolish the statute of limitations" in fraud cases governed by § 2462, which applies not only to the SEC, but potentially to any federal agency. Mr. Lewis Liman, counsel for Petitioners, pointed out an important distinction which would still leave the government wide latitude with respect to non-penalty actions: § 2462 pertains to civil fines, penalties, and forfeitures only, and so does not establish or impose a statute of limitations for governmental *remedial* actions, such as disgorgement or injunctive relief.

One agency that might be affected by the Supreme Court's opinion is the IRS. Circuit Courts of Appeal have declined to apply § 2462 to IRS penalties assessed under 26 U.S.C. §§ 6700 and 6701 pursuant to reasoning similar to that espoused by the SEC in *Gabelli*. Section 6700 imposes a penalty for promoting abusive tax shelters, while § 6701 prescribes penalties for aiding and abetting the understatement of tax liability. The Fifth Circuit, in *Sage v. United States*, cited language that echoes the discovery rule and determined that the assessment of penalties under § 6700 is constrained by *no* statute of limitations because the assessment occurs "only after the IRS becomes aware that an individual's activities are prohibited." The IRS could presumably wait a lifetime, under this reasoning, to assess penalties. The limitations period on *collecting* the civil penalty would begin to run only after the IRS assessed a fine. In *Mullikin v. United States*, the Sixth Circuit cited *Sage* when it issued a similar holding regarding § 6701, reasoning that Congress did not intend a limitations period to apply. The Second and Eighth Circuits have similarly held that § 2462 is inapplicable to § 6700.

If the Supreme Court rules in *Gabelli* that an underlying civil penalty "accrues" when fraudulent conduct takes place, and affords the government no reprieve via the discovery rule, these Circuits' decisions (which hold that the penalty accrues only once *assessed*) would be called into serious question. As Chief Justice Marshall reasoned in 1805, "In a country where not even treason can be prosecuted after a lapse of three years, it could scarcely be supposed that an individual would remain forever liable to a pecuniary forfeiture."

Avoiding "Responsible Person" Liability For Payroll and Sales Taxes

By Chad T. Williams, III

One benefit of conducting business through a corporation, limited liability company or other limited liability entity is the "shield" from personal liability that these entities generally afford stockholders, directors and officers. There are, however, exceptions to this general rule. One such exception is in the case of so-called "trust fund taxes," or those taxes that are collected by a business entity on behalf of the government, such as payroll and sales and use taxes. The willful failure to pay these taxes by one with control over the financial affairs of a business entity may result in personal liability.

During challenging economic times, such as the deep recession hanging over the United States for the last few years, business leaders must navigate complex issues and balance multiple constituencies and priorities. Unfortunately, in the face of these difficult challenges, some corporate fiduciaries

cross the line from shrewd business tactics to illegal or improper conduct. The decision to withhold the payment of "trust fund taxes" is one that may result in temporarily keeping the company afloat, but also expose fiduciaries to significant liability.

Discussion

Section 6672(a) of the Internal Revenue Code (the "Code") imposes penalties on those who are required to collect and pay taxes and "willfully" fail to do so. This is commonly referred to as the "trust fund recovery penalty," so named because the one who is responsible for collecting and paying such taxes is deemed to hold those funds in trust for the government. In determining whether the penalty applies to an individual, the Internal Revenue Service ("IRS") must first determine who is a "responsible person," and then whether that individual was "willful" in failing to pay the taxes to the IRS. While courts consider several factors in determining whether one is a "responsible person," the essence of these different tests is: did the person have knowledge of the underpayment and did he have the ability to control the decision of whether the taxes were paid. Certain corporate titles put individuals squarely in the government's crosshairs, such as "president," "CEO," "CFO" or any other title that connotes control over, or responsibility for, the financial affairs of the company. While generally one who is only a stockholder or only a director would not meet the legal definition of a "responsible person," we have seen cases where a zealous revenue agent will cast a wide net and seek to impose liability on a director or majority owner.

For example, suppose investors provide capital to a business and those investors are elected to serve on its board of directors. The company is growing rapidly, and the board delegates day-to-day management to a CEO, who further delegates specific duties to other members of a management team. During the course of its growth, the corporation experiences a cash crunch and the CEO directs the controller to hold back funds that should be paid to the IRS and instead use those funds to satisfy other obligations. The CEO initially intends to "borrow" the funds and pay them back quickly, but when the company's cash flow crisis deepens the CEO decides to hold back funds again in order to keep the company going. Although the board members have access to the company's banking records and financials, the board has not instituted appropriate internal controls or audit procedures to ensure that the company is satisfying its tax obligations. When the IRS discovers the company's failure to remit payroll taxes, it seeks to impose liability not only on the CEO but also on certain members of the board who the agent believes either knew that the company was not paying taxes or recklessly disregarded the facts. In such a scenario, an otherwise unwitting board member might find herself with tax penalties in the hundreds of thousands or even millions of dollars. Worse, in cases of fraud or other misconduct, certain tax violations also carry the risk of misdemeanor or felony convictions.

Several recent cases demonstrate that while certain titles carry a presumption of liability, it is possible to show that the individual lacked sufficient control or willful conduct to be deemed a "responsible person." These cases also serve as a cautionary tale that should motivate corporate fiduciaries to proactively establish policies and procedures to limit risk or, at a minimum, take immediate action at the first sign of trouble.

Certain Recent Cases

In *Skoczylas v. United States*, the United States District Court for the Eastern District of New York denied the plaintiff's and government's cross-motions for summary judgment. Long Island Health Associates Corp. ("LIHAC") was an entity that was formed to acquire a hospital out of bankruptcy. During the relevant periods, Dvora Skoczylas was a member of the board of directors, the president and the sole stockholder of LIHAC. Although Skoczylas held these titles, she was not actively involved in LIHAC's day-to-day affairs. Throughout the early 2000s, LIHAC was in dire financial condition and had difficulty meeting its obligations, including its tax obligations. Eventually it filed a voluntary Chapter 11 bankruptcy petition, and continued to operate as the debtor in possession. LIHAC's former CFO testified that ***he alone*** made the decision to satisfy other obligations but not the applicable payroll taxes. The former CFO further testified that while he later informed the then-CEO that LIHAC was not paying its payroll taxes, he did not share the IRS correspondence or other information with the CEO or Skoczylas. When Skoczylas learned of the tax liability, she asked the CEO whether LIHAC could use its remaining funds to satisfy the obligation, but he informed her that it could not due to the pending bankruptcy petition. Eventually, the IRS determined that Skoczylas was a "responsible person" who willfully failed to pay certain payroll taxes, and therefore the IRS imposed the trust fund recovery penalty against her. Skoczylas sought to abate the penalty.

The District Court denied the parties' cross-motions for summary judgment, holding that a material fact existed as to whether Skoczylas was a "responsible person" under §6672. Specifically, the court noted that while Skoczylas was president and a member of the board of directors, and owned 100 percent of the stock of LIHAC, there remained an issue of fact regarding other factors bearing on her "control," such as the extent of her management authority and dominion over LIHAC's financial affairs. Moreover, an issue of fact existed as to whether Skoczylas acted "willfully," noting that the "principal component of willfulness is knowledge," and that the parties disputed the extent of her knowledge and involvement throughout the relevant period, particularly given that the former CFO testified that he had not informed her of the issue.

In another recent case, *Stevens v. Commissioner of Revenue*, the Supreme Court of Minnesota held that there was a material dispute of fact regarding whether the president of a convenience store chain had requisite control over the company's finances to be held personally liable for more than $4 million in petroleum and sales taxes, and therefore reversed the state tax court grant of summary judgment in favor of the state Commissioner of Revenue. In that case, Scott Stevens ("Stevens") was the president of Twin Cities Avanti Stores, LLC ("Avanti"), which owned and operated various convenience stores in Minnesota. Stevens owned 1 percent of the "parent" entity of Avanti, while a man named Bruce Nelson ("Nelson") owned 85 percent of the stock of the parent. Nelson, along with a "consultant" named Robert Lovejoy ("Lovejoy") exercised significant day-to-day management responsibilities. Nelson and Lovejoy made most, if not all, of the significant financial decisions involving Avanti while Stevens was primarily responsible for operational matters, including managing personnel and vendor relationships. Stevens presented testimony and evidence, including affidavits from key employees, that Nelson exercised tight control over the company's finances, including the payment of tax liabilities. Moreover, while Stevens negotiated with the Department of Revenue concerning a payment plan for Avanti's tax liabilities, it was Nelson and Lovejoy who were pulling the strings.

The Minnesota Supreme Court held that the tax court erred granting summary judgment in favor of the Commissioner and determining that Stevens exercised sufficient control, supervision and responsibility for collecting and paying Avanti's taxes. The Court believed that the record presented a dispute of material fact as to whether Stevens, despite his title and responsibilities as president and his stock ownership, lacked sufficient control to be held personally liable for the $4 million tax liability.

Conclusion

These cases are but a sample of recent cases involving officers of companies who are exposed to significant financial penalties and, in some cases, criminal liability for failure to properly manage and satisfy tax obligations. While the facts of each case differ, the general theme is usually the same: a company hits a financially difficult period; one or more officers or directors look for ways to maximize cash to keep the company afloat; a decision is made to hold back tax payments and when the company's financial condition does not improve, the tax liability grows and the IRS gets involved and assesses liability. In such cases, liability may extend not only to the officer or director primarily responsible for withholding payment of the taxes, but also to those deemed to be a "responsible person" who exercises sufficient control over financial affairs and acts " willfully," with knowledge of the non-payment. What is unique about the cases discussed above is that, notwithstanding the presumption that one who carries the title "president" or a similar title that connotes financial control is a "responsible person," in some cases an individual might be able to demonstrate that the title is misleading and he did not possess control or did not act "willfully," and therefore should not be liable for the trust fund penalty.

These cases also illustrate the importance of taking proactive measures to limit personal risk. For example, a company should establish policies and procedures, such as an audit committee, with responsibility for oversight of the company's financial operations and tax payments. In addition, the board might ensure that no one officer has complete control over the day-to-day financial responsibilities of the company. The bottom line is, it is simply not enough for directors or officers to delegate authority to another officer or employee and expect that such delegation will insulate the person from liability. Indeed, if one discovers that an officer or director is failing to pay applicable taxes, he or she should take immediate action to ensure prompt payment of those taxes (if within that person's control) or possibly resign his position with the company. In any case, it is extremely important to consult with legal counsel before speaking with the IRS to ensure that the individual does not expose himself to greater liability than might otherwise be present under the circumstances.

Environmental Crimes and Punishment

By Randall M. Lutz

A few years ago the president of a well-known food brand was convicted and sentenced to serve nine months in federal prison for failing to stop his plant from engaging in a practice that he knew was a violation of environmental laws. A former disgruntled employee who knew of the practice turned the company in to the federal authorities. The practice, emptying a 10,000 gallon food waste vat into the river each month in the middle of the night, was serious enough to cause substantial, although temporary, environmental degradation to a major river in Washington state. Federal agents used infrared video cameras to record the violation as it was occurring.

The federal prosecutor decided to charge the company president, who was subsequently found guilty of violating federal law. The president was an extremely popular and philanthropic person, and was very active in civic and community affairs — over 100 people wrote to the judge asking not to send their civic leader to jail. However, the judge agreed with the prosecutor and felt that only jail time would deter future illegal behavior.

The above scenario is not a hypothetical; it is an actual case. Facts like these raise eyebrows in the corporate board room and at the family dinner table alike. To preemptively answer some of the questions raised by the case: Yes, judges sentence people to jail time for serious environmental violations. Yes, you can be convicted of a crime for *not* doing something when you had the knowledge, power and authority to stop the misconduct and failed to do so. Yes, it is prosecutorial policy to charge the highest culpable official of a company committing a crime. And, yes, a person's wealth is a factor in determining whether the sentence would be a satisfactory deterrent to future actions of the defendant and the community.

Regarding environmental crimes, you should know that most states, particularly in the Northeast, have units of specially trained environmental police, typically as part of the state police. They get their cases from referrals by state and local environmental inspectors who find out about egregious or intentional violations from disgruntled employees, environmental volunteers who inspect water bodies (like the River Keepers), and the general public. The federal government also has environmental criminal police in the Environmental Protection Agency ("EPA") and other agencies. Environmental regulators can be relentless and caution needs to be exercised if they come knocking on your door.

For deterrent purposes, it is the policy of prosecutors to charge the highest culpable official in a company committing a crime. This includes acts or omissions by corporate officers by essentially "looking the other way" at environmental violations. There is a question as to how much knowledge of an actual act is necessary for there to be this deliberate indifference by an official. Creating a policy, effectively insulating officials from knowledge of violations, that furthers a criminal act by deliberate indifference may be enough for a conviction without knowledge of the actual act.

Many corporate officials are better compensated than the average person. At some level of wealth, which is fully revealed to a judge in a presentence report, a judge may not feel that fining a defendant would send the correct message and deter future illegal action by the defendant *or the community*. That is why many wealthy tax violators are sent to prison, not just fined. It is no different with environmental crimes. The same factors are considered by the judge for sentencing. In the federal courts the judges must follow the mandatory sentencing guidelines, which usually start with a minimum of a $250,000 fine in addition to jail time.

A lot has changed over the last few decades in enforcement of environmental laws. Investigatory techniques and equipment have improved exponentially. Targeting by police and prosecutors has become more sophisticated. Required monitoring and self-reporting make violations difficult to hide. Do not wait until it is too late to seek help and guidance when environmental regulators appear at the front door.

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Federal District Court in New Jersey Closes Door (Again) on Selective Waiver

By Christine M. Pickel

Subjects of government investigations routinely face the question: To be or not to be forthcoming with information otherwise protected by the attorney-client privilege? A recent opinion out of the District of New Jersey has not made the decision any easier, though it does tell counsel and their clients very clearly that the bounds of the attorney-client privilege do not extend to information produced during the course of a government investigation. This guidance allows subjects of government investigations the opportunity to make informed decisions when balancing whether to disclose privileged information to a government agency in the course of an investigation.

In *In re Merck & Co., Inc. Securities, Derivative & "ERISA" Litigation*, No. 2:05-cv-02367-SRC-CLW (District of New Jersey), Merck had provided certain documents protected by the attorney-client privilege to the Department of Justice ("DOJ") in the course of a prior criminal investigation. Merck disclosed the otherwise privileged documents pursuant to an agreement with the DOJ under which (1) the DOJ promised to maintain the confidentiality of the documents; and (2) Merck's purported limited waiver of the attorney-client privilege as to the DOJ would not extend to any other third party. In the subsequent civil litigation, Plaintiffs sought to compel Merck to produce documents, including those that Merck had disclosed in the criminal investigation pursuant to the confidentiality agreement. Merck countered that those documents remained protected by the attorney-client privilege pursuant to the selective waiver doctrine. District Judge Chesler of the District of New Jersey rejected Merck's argument in its entirety, writing that Third Circuit precedent based on *Westinghouse v. Republic of the Philippines* "clearly instructs that applying selective waiver in the context of voluntary disclosure to government agencies would amount to an unjustified expansion of the attorney-client privilege."

In *Westinghouse*, the Third Circuit declined to adopt the "celebrated and controversial selective waiver theory fashioned by the Eighth Circuit in *Diversified Industries, Inc. v. Meredith* and resoundingly rejected by the D.C. Circuit in *Permian Corp. v. United States*. The selective waiver doctrine, when applied, allows a party to disclose to a government agency attorney-client privileged materials while maintaining confidentiality of those materials as to all other parties, including those involved in subsequent civil litigation with the disclosing entity. In rejecting the selective waiver theory in 1991, the Third Circuit examined the underpinnings of the attorney-client privilege, holding:

> . . . selective waiver does not serve the purpose of encouraging full disclosure to one's attorney in order to obtain informed legal assistance; it merely encourages voluntary disclosure to government agencies, thereby extending the privilege beyond its intended purpose. . . . [T]o go beyond the policies underlying the attorney-client privilege . . . would be to create an entirely new privilege.

Twenty years later, in *Merck*, the disclosing party argued that the *Westinghouse* decision did not apply to the documents Merck had disclosed in the prior government investigation. Merck attempted to distinguish its agreement with the DOJ from the confidentiality agreement in *Westinghouse*. Merck argued that *Westinghouse* left open the possibility that an agreement between the disclosing party and government agency purporting to preserve the privilege as to third parties could in fact preserve the attorney-client privilege as to third parties. The District of New Jersey disagreed with this analysis and noted that Merck's argument was based on an observation made by the Third Circuit in *dicta* that the agreement

in *Westinghouse* did not attempt to preserve the privilege as to third parties. The District Court noted that the Third Circuit's observation did not provide a basis for its decision; rather, the Third Circuit rejected the selective waiver theory because it impermissibly expanded the parameters of the attorney-client privilege.

Although the District of New Jersey's conclusion is not surprising, it firmly shuts the door once again on the selective waiver doctrine. The opinion reminds litigants that courts in the Third Circuit have emphatically rejected the theory – and do not appear to be reconsidering this position in the short term. This means that subjects of government investigations must continue to weigh the benefits of disclosure to an investigating agency (i.e., cooperation and credibility points) against the potential detriment that may result when third parties in parallel or subsequent action gain access to the otherwise privileged documents. Ultimately, a party which elects to disclose documents to the government may not be able to assert a privilege to later protect disclosed information. With the assistance of counsel, though, the party can prepare a strategy for dealing with the effects, if any, of the disclosure.

Supreme Court Grants *Certiorari* on Government's Petition Regarding Judicial Participation in Plea Negotiations

By Christine M. Pickel

On January 4, the Supreme Court of the United States granted the government's petition for *certiorari* in an appeal involving Federal Rule of Criminal Procedure 11(c)(1). *See United States v. Davila*, No. 12-167. Rule 11(c)(1) provides that "[a]n attorney for the government and the defendant's attorney, or the defendant when proceeding *pro se*, may discuss and reach a plea agreement. The court must not participate in these discussions." Rule 11(h) states that "[a] variance from the requirements of this rule is harmless error if it does not affect substantial rights."

At issue in *Davila* is whether the Court of Appeals for the Eleventh Circuit "erred in holding that any degree of judicial participation in plea negotiations, in violation of Federal Rule of Criminal Procedure 11(c)(1), automatically requires vacatur of a defendant's guilty plea, irrespective of whether the error prejudiced the defendant." In the underlying criminal proceedings, a magistrate judge encouraged Davila to follow his court-appointed counsel's advice to enter a guilty plea. Davila did so. He was then convicted of a conspiracy charge related to identity theft and filing falsified tax returns and sentenced to 115 months in prison.

In reviewing Davila's request to set aside his conviction on other grounds, the Eleventh Circuit *sua sponte* sought briefing on whether reversible error had occurred under Rule 11(c)(1). The parties did not dispute that the magistrate judge made statements to Davila in contravention of Rule 11(c)(1). Rather, the government argued that Davila could not satisfy the plain error standard by showing that the violation affected his substantial rights. The Eleventh Circuit applied the plain error standard, held that Davila need not prove individual prejudice as a result of the Rule 11(c)(1) violation, vacated the conviction, and remanded for further proceedings. In holding that Davila need not prove prejudice, the Eleventh Circuit acknowledged that other circuits apply a harmless error standard with respect to judicial participation in plea negotiations. However, based on Circuit precedent,

the Eleventh Circuit declined to apply a harmless error standard, instead applying Rule 11(c)(1) as a "bright line rule."

It is likely that in granting *certiorari* and deciding the issue presented, the Supreme Court will resolve this split among the circuit courts. Defense attorneys will want to stay abreast of developments. The *White Collar Watch* will continue to monitor this case and provide an update on the Supreme Court's decision.

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