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WHITE-COLLAR CRIME

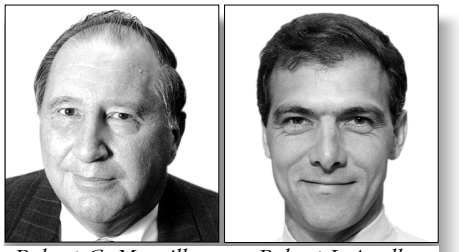
BY ROBERT G. MORVILLO AND ROBERT J. ANELLO

Joint Defense Agreements, Insider Trading Misappropriation Theory

ONE OF THE regrettable byproducts of the federal sentencing guidelines (U.S. Sentencing Commission Guidelines) has been that the development of substantive federal criminal law, in large part, has been arrested. Analysis of circuit court opinions reveals that they are lopsided in dealing predominately with guideline issues. The dearth of trials and their accompanying pretrial motions has contributed to this phenomena. Thus, it is pleasant to be able to write about several recent non-guideline opinions: the first two involving the increasingly important area of joint defense agreements and the other helping to define the parameters of the court-created insider trading misappropriation theory.

Joint Defense Agreements

Joint defense agreements provide some, although by no means ironclad, assurance that if one party to such an agreement defects and becomes a government witness, information shared under the umbrella of the joint defense agreement will not fall into the government's hands, or, at least will not be overtly used against the non-cooperating defendants.[1] Far less clear is whether counsel for a noncooperating defendant



Robert G. Morvillo *Robert J. Anello*

faces any limitations in cross-examining a witness who has abandoned a joint-defense agreement with his client and is cooperating with the government. Does the defense attorney owe the former member of the joint defense arrangement a duty of loyalty or confidentiality that would restrict cross-examination?

In a recent decision issued in *United States v. Almeida*,[2] the U.S. Court of Appeals for the Eleventh Circuit answered this question in the negative, vacating the conviction of a defendant whose attorneys were prevented from effectively cross-examining a cooperating defendant who previously had been party to a joint defense agreement with their client. In exchange for his testimony against defendant Mr. Almeida, the government agreed to drop 29 out of 30 counts against the cooperator. The prosecutor, apparently acting as counsel for the cooperating witness, successfully sought to curtail his cross-examination by Mr. Almeida's attorneys, asserting that the attorney-client privilege extended to any communications between the cooperating witness and Mr. Almeida's attorneys. The government contended that when the witness spoke to Mr. Almeida's attorney "it was just as if [he] was talking to his own attorney." The prosecutor argued that cross-examination of the witness thus presented a classic case of divided loyalties, and sought an order preventing Mr. Almeida's attorneys from using any confidential information they had obtained from the witness during the two years of the joint defense agreement's operation.[3]

The district court rejected the argument that Mr. Almeida's attorney was laboring under a conflict of interest. It did, however, accept the prosecution's argument that eliciting or using confidential information obtained during the joint defense agreement during cross-examination of the cooperating witness would be improper and, accordingly, precluded defense counsel from using such information during cross-examination.

After Mr. Almeida was convicted, the cooperating witness decided to waive any privileges, recanted his testimony against Mr. Almeida, and gave a sworn statement that Mr. Almeida was in fact not guilty. He also stated that he had told this to Mr. Almeida's attorneys during a joint defense meeting, and that he had changed his story in order to obtain leniency from the government. He revealed that two of the other principal witnesses against Mr. Almeida had concocted and coordinated their stories against him in an effort to have their sentences reduced. When the defendant moved for new trial, the trial court acknowledged that it had erred in

Robert G. Morvillo *and* **Robert J. Anello** *are partners at Morvillo, Abramowitz, Grand, Iason & Silberberg.* **Judith L. Mogul,** *an attorney, assisted in the preparation of this article.*

limiting the cross-examination of the cooperating witness, reasoning that once he defected to the prosecution's camp, he had no privilege with respect to Mr. Almeida's counsel. The court nevertheless determined that the error was harmless and denied the motion for a new trial.

The Eleventh Circuit reversed, finding that the district court had abused its discretion in precluding Mr. Almeida's attorneys from using joint defense communications in cross-examining the cooperator. The court observed at the outset, that "[w]hen a defendant conveys information to the lawyer of his co-defendant, as opposed to his own lawyer, the justification for protecting the confidentiality of the information is weak." It observed that the strongest rationale for keeping joint-defense information confidential is to provide co-defendants the opportunity to counter the "vast resources of the government" by collaborating in a confidential fashion without forcing them to hire the same attorney — a situation, it noted "that is almost always ripe with real conflicts of interest."

The appellate court went on to discuss two longstanding exceptions to the attorney-client privilege. The first recognizes that where an attorney represents two parties sharing a common interest, neither party may assert the privilege against the other in a subsequent dispute. The second is based on the "ancient rule" that when an accomplice testifies for the prosecution against co-defendants, he waives the attorney-client privilege as well as the privilege against self-incrimination. Recognizing that both of these exceptions are open to criticism for eroding confidence in attorney-client confidentiality, the court stopped short of holding that accomplices always waive the privilege when they testify on behalf of the government, or that jointly represented individuals always waive the privilege when one decides to testify for the prosecution against the other. But, in the context of a joint defense agreement, the court held that the rationale for waiver outweighs the minimal benefit of the attorney-client privilege. It concluded that "when a party to a joint defense agreement is represented by his own attorney, [communications made by one defendant to the other's attorney] do not get the benefit of the attorney-client privilege in the event that the co-defendant decides to testify on behalf of the government. …"

The joint defense agreement at issue in *Almeida* was an oral agreement. The defendant in that case benefitted from the fact that neither the government, nor the former member of the agreement disputed its existence or scope, and that the court of appeals adopted a rule that was highly protective of the non-defecting member of the joint-defense agreement even in the absence of a written waiver.

Earlier this year, the U.S. District Court for the Northern District of California took an unusual and more proactive approach in a multi-defendant case, requiring the defendants, at the outset of a prosecution, to submit any proposed joint defense agreements for its approval "out of concern for the Sixth Amendment rights of the defendants and the integrity of the proceedings." The court believed that it had inherent supervisory power to regulate these agreements, even over the objection of defense counsel. The court in *United States v. Stepney*,[4] ordered that joint defense agreements in that case must: (1) explicitly disclaim that they create any type of attorney-client relationship between any defendant and counsel for another defendant in the case; (2) provide that attorneys will owe a duty of confidentiality to those who are not their clients, but that no concomitant duty of loyalty exists between the lawyer and those members of a joint-defense agreement the lawyer does not actually represent; (3) contain a conditional waiver of confidentiality permitting a signatory attorney to cross-examine any defendant who testifies at any proceeding using any material contributed by the witness during the joint-defense; and (4) expressly allow any defendant to withdraw from the agreement upon notice to the other defendants.

The court held that to impose on attorneys a duty of loyalty to their clients' co-defendant would "create a minefield of potential conflicts" that would require withdrawal of counsel required to cross-examine another member of a joint defense agreement, or even where a defendant pursued a defense that conflicted with the defenses of the other participants in the joint defense agreement. The court went on to note that "[d]isqualification of attorneys late in the proceedings benefits no one — it deprives defendants of counsel whom they know and trust and perhaps even chose; it forces delays while new counsel become acquainted with the case, which harm defendants, the prosecution, and the court."

Dismissal of Fraud Charge

The second noteworthy defendant's victory was in *United States v. Cassese*,[5] in which Southern District Judge Robert W. Sweet dismissed, as legally insufficient, one of two criminal securities fraud charges in an indictment alleging that the defendant had traded based on material, nonpublic information.

As charged in the indictment, the defendant, Mr. Cassese, was the chairman and president of Computer Horizons, a firm that provided temporary computer and information technology personnel. During the spring of 1999, he participated in discussions with Compuware Corp., another company in the same industry that had expressed an interest in acquiring Horizons. In the course of those negotiations, Compuware sent the defendant a letter of intent setting forth the proposed terms of the transaction, as well as a confidentiality agreement, which sought to prohibit any employee of Horizons from trading on any material, nonpublic information learned during the course of the merger discussions. Nobody from Horizons ever executed that agreement. At that time, Compuware was simulta-

neously engaged in merger discussions with a second company, Data Processing Resources Corp., and in early June 1999 reached an agreement to purchase that company instead. On June 21, 1999, Compuware's CEO informed the defendant that the contemplated transaction between Compuware and Horizons would not take place because Compuware would be acquiring Data Processing Resources.

The indictment charged that at the time of this conversation, Mr. Cassese was aware that the proposed acquisition of Data Processing Resources had not been announced. It further alleged that the following day, he placed orders to purchase 15,000 shares of Data Processing Resources stock, which he sold two days later, at a profit of more that $150,000, following board approval of the proposed tender offer and the press release publicly announcing the acquisition. The defendant was charged in a two-count indictment with securities fraud in connection with a tender offer in violation of §14(e) of the Securities Exchange Act of 1934 and Rule 14e-1 thereunder, and with securities fraud under §10(b) of the Securities Exchange Act of 1934, and Rule10b-5 thereunder.

On motion of astute defense counsel, Judge Sweet dismissed the §10(b) count, holding that even if all the allegations in the indictment were proved, they would not establish securities fraud in violation of that section.[6] He observed that §10(b) and Rule 10b-5 support two general theories of liability for trading on material non-public information. The first, traditional insider trading, requires that the defendant be a corporate insider who trades in his own company's stock or received a tip from a corporate insider who was himself violating a fiduciary duty in disclosing the information. The indictment did not allege that Mr. Cassese was a corporate insider, or that the Compuware CEO breached any legal duty by disclosing its intention to acquire Data Processing Resources to Mr. Cassese.

The government chose instead to proceed against Mr. Cassese under the misappropriation theory, which imposes liability under §10(b) when a person "misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information."[7] Judge Sweet noted that misappropriation turns, not simply on whether a defendant has traded based on material, non-public information, but on whether he has done so in violation of a "fiduciary duty or similar relationship of trust and confidence" owed to the source of the information. Relying on the Second Circuit's earlier decision in *United States v. Chestman*,[8] he stressed that such a duty "cannot be imposed unilaterally by entrusting a person with confidential information." *Chestman* cautioned that "[t]ethered to the field of shareholder relations, fiduciary obligations arise within a narrow, principled sphere," where one party has reposed confidence in the other, resulting in some dominance, superiority or influence. Judge Sweet noted that the types of associations that have been held to be inherently fiduciary include attorney and client, executor and heir, trustee and beneficiary, and senior corporate official and shareholder.

Judge Sweet went on to examine the relationship between Mr. Cassese and the Compuware CEO against this backdrop. He concluded that their status as business competitors engaged in negotiations for a possible merger cast them in the roles of potential arm's-length business partners rather than fiduciaries. In reliance on *Chestman*, Judge Sweet noted that a duty of confidentiality may be implied in certain instances, but only from a pre-existing fiduciary-like relationship between the parties. In this case, the defendant's position was undoubtedly strengthened by the fact that the confidentiality agreement proposed by Compuware never was executed — a fact that Judge Sweet suggested might be seen as an actual rejection of any duty of confidentiality. Because the information on which Mr. Cassese traded was obtained through a relationship "best characterized as an equal relationship between peers," rather than one "involving a degree of dominance," Judge Sweet concluded that the §10(b) charge contained in the indictment failed as a matter of law.

One other recent case from the Northern District of California dealt with an unusual theory in the context of inside information obtained at a business club for which membership was predicated on compliance with a written confidentiality commitment.[9] The court dismissed these charges holding that "even if the members of [the club] were bound by an express confidentiality agreement, that agreement appealed only to the members' ethics and morality; it did not give rise to any legal duties."

The amorphous state of insider trading law, as prosecutors continue to try to expand it, raises the question anew as to whether Congress will ever intervene to bring clarity and cohesion to this aspect of the law.

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(1) See *United States v. Schwimmer*, 892 F2d 237 (2d Cir. 1989); *United States v. Aulicino*, 44 F3d 1102 (2d Cir. 1995).

(2) 2003 WL 21957162 (11th Cir. Aug. 18, 2003).

(3) The prosecutor also sought, but did not obtain, a hearing pursuant to Rule 44(c) so that the court could obtain a waiver of this conflict from Mr. Almeida or require his counsel to withdraw for the purposes of cross-examining the cooperating witness.

(4) 246 FSupp2d 1069 (NDCal 2003).

(5) 2003 WL 21710765 (SDNY July 23, 2003).

(6) The defendants did not seek to have the §14(e) count dismissed. Trial on that count ended in a hung jury on Sept. 22.

(7) *United States v. O'Hagan*, 521 US 642 (1997).

(8) 947 F2d 551 (2d Cir. 1991).

(9) See *United States v. Kim*, 184 FSupp2d 1006 (N.D. Cal. 2002).