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WHITE-COLLAR CRIME

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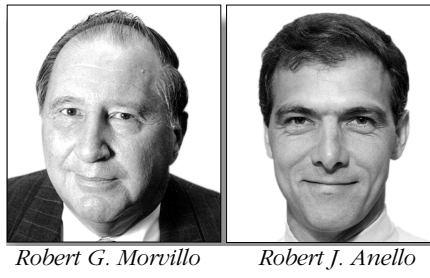
Mens Rea for Criminal Securities Prosecutions

PROSECUTORS stretching to bring white-collar prosecutions based on novel interpretations of criminal statutes suffered a set-back last month when Southern District Judge Robert W. Sweet granted the defendant's motion for a judgment of acquittal pursuant to Rule 29(c) in *United States v. Cassese*.¹ Judge Sweet took this unusual step after finding no evidence on which the jury could have found beyond a reasonable doubt that the defendant had the requisite culpable state of mind to satisfy the requirement that he willfully violated the securities laws, as required for a criminal conviction by §32(a) of the Securities Exchange Act of 1934.² Willfulness, a required element under a number of different types of federal criminal statutes including tax and copyright, as well as the securities laws under which Cassese was prosecuted, is an elusive concept taking on different meanings depending on the particular crime charged. Whether in the form of a legal challenge or a factual defense, such as was used in the recent trial of Frank Quattrone which ended in a hung jury, willfulness and related intent requirements offer defense lawyers a potential advantage to the extent prosecutors are required to produce evidence of what was going on in the defendant's mind.

Meaning of Willful

The U.S. Supreme Court has recognized

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that "willful" is a "word of many meanings," and "its construction [is] often ... influenced by its context."³ Thus in some instances, such as criminal tax fraud⁴ or structuring of monetary transactions,⁵ the government must show that the defendant was aware of the specific law that he was violating in order to prove willfulness. For other crimes, such as selling firearms without a licence, the willfulness requirement may be satisfied by a showing that the defendant knew that his conduct was unlawful, but does not require proof that the defendant knew of the particular statute at issue. In still other cases, such as witness tampering,⁶ or where a union official is charged with illegally accepting payment from an employer,⁷ proof of willfulness requires no more than proof of general intent — that the defendant acted deliberately and voluntarily. Willfulness under the federal securities laws has been defined to mean "a realization on the defendant's part" that he was doing a wrongful act.⁸ Because the Cassese prosecution was limited to one narrow securities law violation involving allegedly improper trading pertaining to a tender offer, it invited a focused look at the meaning of willfulness under the federal securities laws

— a level of scrutiny that the government's case could not withstand.

The government's case against John J. Cassese arose out of his purchase and sale of securities in a corporation (DPRC) based on inside information he had concerning that company's acquisition by another corporation. The acquiring corporation (Compuware) previously had been engaged in negotiations to purchase the defendant's company (Computer Horizons), but decided instead to acquire DPRC, a competitor of the defendant's company. Cassese learned of Compuware's plans to purchase his competitor in a brief telephone conversation with a Compuware executive, during which he was informed that the deal to buy his company would not proceed and that the acquiring company instead would be purchasing DPRC. No details concerning that transaction were discussed. The following day, Cassese made two separate purchases of DPRC stock, which he sold immediately after Compuware's purchase of DPRC was announced.

After settling SEC civil enforcement proceedings against him based on these trades, Cassese was indicted on two counts of criminal insider trading. The first count charged him with violating Rule 10(b), and was dismissed before trial by Judge Sweet (in a decision discussed in our October column) because Cassese did not owe, and thus did not violate any fiduciary duties to either Compuware or DPRC. The remaining count charged Cassese with violating §14(e) and Rule 14e-3, which prohibits a person in possession of material, non-public information concerning a tender offer, from trading on that information if any person

has taken substantial steps to commence, or has commenced the tender offer.

The first trial on the 14e-3 count ended in a hung jury. Cassese was found guilty by the jury following the second trial. Judge Sweet granted the defendant's post-trial motion for acquittal pursuant to Rule 29(c), accepting the defendant's argument that under §32(a), in order to be convicted of a criminal violation of the securities laws, the government needed to prove that the defendant acted willfully, and that in this case, because the evidence failed to establish that the defendant knew that the impending acquisition of DPRC would be a tender offer, it had failed to meet that burden.

Two-Step Process

In most instances, establishing a criminal violation of the federal securities laws is a two-step process.⁹ First, the government must show that the defendant violated a particular provision of or rule promulgated under either the 1933 Act or the 1934 Act. Such a showing suffices to establish civil, but not criminal liability. For criminal sanctions to attach, the government also must prove that the defendant acted with the requisite mental state required under either §24 of the 1933 Act¹⁰ or §32(a) of the 1934 Act. Section 32(a) provides for criminal fines and imprisonment for "[a]ny person who willfully violates any provision of this title. . . or any rule or regulation thereunder the violation of which is made unlawful or the observance of which is required under the terms of this title," or any person who willfully and knowingly makes, or causes to be made a false or misleading statement in a required document. That section further provides that "no person shall be subject to imprisonment under this section for the violation of any rule or regulation if he proves that he had no knowledge of such rule or regulation."

Section 32(a) thus makes an unusual distinction between the mental state required for a criminal conviction and that required to impose a sentence of imprisonment, permitting the former based solely on proof of willfulness and prohibiting the latter where defendant did not know of the rule or regulation violated by his conduct.

Knowledge of Tender Offer

In *Cassese*, the government conceded that it was required to prove that the defendant acted willfully under §32(a). It argued, however, that it did not need to establish that the defendant knew that the transaction on which he based his trade was a tender offer, but only that he intentionally undertook the trades in question, adopting what the court referred to as a "trade at your peril" standard for criminal liability. This argument has some surface appeal, because courts consistently have held that knowledge of a tender offer is not an element of a Rule14e-3 violation.¹¹

Although Judge Sweet accepted the prosecution's contention that knowledge of a tender offer is not an element of a 14e-3 violation, he stressed that the analysis did not end there. He noted that §32(a) imposed an independent mens rea requirement of willfulness for criminal liability, and found that in the circumstances of this case, this meant that defendant could not be criminally liable for his violation of 14e-3 unless he knew that the inside information on which he traded related to a tender offer.

Separate Mens Rea

The definition of willfulness for the purposes of §32(a) in this circuit is governed by Judge Friendly's decisions in *United States v. Peltz*,¹² and *United States v. Dixon*.¹³ Parsing the language of §32(a), *Peltz* held that "a person willfully can violate an SEC rule even if he does not know of its existence." Judge Friendly reasoned that this conclusion follows from the difference between the standard for violation of the statute or rule or regulation, to wit, "willfully," and that for false and misleading statements, namely "willfully and knowingly." He found further support for this conclusion in the proviso at the end of §32(a) that permits imposition of a fine, but not imprisonment, where the defendant lacks knowledge of the rule or regulation violated. But, as the *Dixon* court stressed, despite the restrictive meaning given to "willfully" in §32(a), "the term must have some meaning." Echoing his earlier holding in *Peltz*, Judge Friendly explained in *Dixon*

that to establish that a defendant acted willfully for purposes of §32(a), the prosecution must prove "a realization on the defendant's part that he was doing an act that was wrongful under the securities laws and that the knowing, wrongful conduct involve a significant risk of effecting the violation that has occurred."¹⁴

Cassese presented the question of how to define willfulness for a 14e-3 prosecution in an unusually sharp light. The overwhelming majority of prosecutions for violation of Rule14e-3 are paired with more general insider trading claims under §10(b). When that is the case, willfulness for both charges can be established through proof of the intent to violate §10(b)'s more general prohibition against insider trading based on information acquired through the breach of a fiduciary duty. In such instances, where the defendant's knowledge that his conduct is wrongful can be established through evidence that he knew he was violating a fiduciary duty or misappropriating insider information, separate proof of intent with respect to the more specific violation proscribed by Rule 14e-3, predicated on the existence of a tender offer, is not required. The unusual posture of the *Cassese* prosecution, involving a Rule 14e-3 charge standing alone, required the court, for the first time, to determine the meaning of willfulness as that term is used in §32(a) in the context of a §14(e) violation.

Based on *Peltz* and *Dixon*, Judge Sweet concluded that although the government, in theory, did not have to prove that Cassese had knowledge of the tender offer, it did have to establish Cassese's belief that he committed an illegal act. In this case, because no general prohibition exists on trading on material non-public information absent the breach of a fiduciary duty or misappropriation of the inside information, the only thing unlawful about Cassese's trading was that it related to a tender offer. Accordingly, for Cassese to have had the requisite wrongful motive for criminal liability, he would had to have believed that the information on which he traded related to a tender offer. Judge Sweet cautioned that "[t]o conclude otherwise would impose absolute liability for those who trade on

material nonpublic information, and this is not the law.”

Weight of the Evidence

Having determined that the unique circumstances of this stand-alone 14e-3 prosecution required proof that Cassese knew that Compuware’s acquisition of DPRC was a tender offer, Judge Sweet turned to an examination of the evidence to determine if it could support the jury’s verdict on that score. In support of its position that the verdict was properly supported, the government pointed to (1) the fact that Cassese made his purchases of 15,000 shares in two batches (one of 10,000 and another of 5,000), through two brokers and two accounts; (2) the timing of the purchase (the day following the phone call in which he learned that Compuware planned to buy DPRC); (3) a desire he expressed to cancel the trades after the acquisition was announced; (4) a conversation, months after the fact, in which he expressed regret at having made the purchases; (5) the letter of intent in which Compuware proposed to purchase the defendant’s company by tender offer or cash merger and an accompanying proposed confidentiality agreement; (6) and Cassese’s personal knowledge of the securities laws.

Judge Sweet found that none of this evidence was probative of the fact that Cassese knew that he was committing a wrongful act. His use of the two brokers did not indicate an effort to conceal his trading in DPRC stock because it was typical of his investing pattern, and, in the court’s view, made it no less likely that his trades would be detected. Judge Sweet also noted that the timing of this stock purchase offered no evidence of willfulness because if Cassese believed that the purchases were legal, he would have had no reason to delay making them. The judge similarly discounted evidence that Cassese had inquired into canceling the trades the day following their purchase, stressing that this desire offered no evidence of his intent at the time the trades were made, and based on the proposition that “[a]fter the fact ‘consciousness of guilt evidence’ is insufficient as a matter of law to sustain a conviction.”¹⁵

Judge Sweet also rejected the government’s effort to support the verdict through a conversation between Compuware’s investment banker and Cassese, in which Cassese expressed regret for having made the trades two months after the fact. He noted that the banker did not recall Cassese acknowledging that he had acted improperly, and that regretting the trades was hardly surprising in light of the trouble they had caused Cassese.

Judge Sweet also held that the letter of intent concerning the purchase of defendants’s company revealed nothing of the defendant’s mental state with respect to the DPRC transaction, particularly because it contained no indication that Compuware intended to use a tender offer as its exclusive method of merger, even for the transaction to which it related. Evidence of the proposed confidentiality agreement was similarly unavailing because it was unsigned and the government did not introduce any evidence that Cassese even had reviewed it.

Finally, Judge Sweet held that Cassese’s longstanding position as CEO of a publicly traded company, although it may have constituted some evidence of his knowledge of certain aspects of the securities laws, did not indicate that he had ever participated in a tender offer or had experience with §14(e) or Rule 14e-3. In fact, he observed, Cassese’s knowledge of the securities laws may have led him to think his trading was perfectly legal, based on the fact that the trades did not relate to his own company’s stock, that he was not an insider, that he owed no duty to Compuware, and that he had no knowledge that the transaction was a tender offer.

After determining that none of these factors constituted evidence of the defendant’s willfulness, Judge Sweet considered the totality of the evidence in the light most favorable to the government in order to determine whether the jury could have found the defendant guilty beyond a reasonable doubt. Quoting from the Second Circuit’s recent decision in *United States v. Glenn*,¹⁶ he noted that “if all the evidence ‘viewed in the light most favorable to the prosecution gives equal or nearly equal circumstantial support to a

theory of guilt and a theory of innocence, then a reasonable jury must necessarily entertain a reasonable doubt.’”¹⁷ Applying this standard, Judge Sweet found that all of the evidence, taken together, gave at most “‘equal circumstantial support’ to competing explanations of Cassese’s intent,” and as such failed to establish Cassese’s guilt beyond a reasonable doubt.

Although Cassese’s battle may not yet be over, (the government filed a notice of appeal the day following Judge Sweet’s order granting the defendant’s motion for an acquittal)¹⁸ Cassese’s victories up until this point underscore the value in scrutinizing and challenging the legal and factual theories employed by the government in its current zeal to prosecute white-collar cases.

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(1) No. 03 Cr. 302 (RWS), 2003 WL 22674262 (Nov. 13, 2003). Judge Sweet’s earlier dismissal of a charge that the defendant violated §10(b) was discussed in our Oct. 7, 2003 column.

(2) 15 U.S.C. §78ff(a).

(3) *Ratzlaf v. United States*, 510 U.S. 135 (1994); *Spies v. United States*, 317 U.S. 492 (1943).

(4) *United States v. Cheek*, 498 US 192 (1991).

(5) *Ratzlaf v. United States*, 510 U.S. 135.

(6) *United States v. Gabriel*, 125 F3d 89 (2d Cir. 1997).

(7) *United States v. Georgopoulos*, 149 F3d 169 (2d Cir. 1998).

(8) *United States v. Peltz*, 433 F2d 48, 55 (2d Cir. 1970); *United States v. Dixon*, 536 F2d 1388, 1395 (2d Cir. 1976).

(9) The criminal provisions of the The Sarbanes-Oxley Pub. L. No. 107-204, 116 Stat. 745 (2002), 15 U.S.C. §7201 are the exception to this rule. Section 807 sets out the new securities crimes contained in the Act, which are codified separately from other securities fraud crimes under the Securities Act of 1933 and the Securities Exchange Act of 1934, and which contain their own independent basis for criminal liability.

(10) 15 U.S.C. §§77x (2002).

(11) See, *Cassese*, 2003 WL 22674262 at 5, citing cases including *United States v. Chestman*, 88 Cr. 455 (JMW)(S.D.N.Y.)(jury was instructed that “[i]t is not necessary that the defendant knew that the information related to a tender offer, as long as the information did, in fact, relate to a tender offer.”), *aff’d* 947 F.2d 551 (2d Cir. 1991) (en banc); *United States v. Robles*, 00 Cr. 1169 (RMB)(S.D.N.Y.) (same).

(12) 433 F2d 48 (2d Cir. 1970).

(13) 536 F2d 1388 (2d Cir. 1976).

(14) *Peltz*, 433 F2d at 55; *Dixon*, 536 F2d at 1395.

(15) 2003 WL 22674262 at 9, citing, *inter alia*, *United States v. Johnson*, 513 F2d 819 (2d Cir. 1975); *United States v. Glenn*, 312 F3d 58 (2d Cir. 2002).

(16) 312 F3d 58 (2d Cir. 2002).

(17) 2003 WL 22674262 at 11, quoting *United States v. Glenn*, 312 F3d at 70 (internal citations omitted).

(18) Filing the notice of appeal does not necessarily indicate that the prosecution will in fact appeal this decision. It merely preserves that option while the government determines whether an appeal is appropriate and seeks permission from the Solicitor General to appeal.

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