New York Law Journal
SERVING THE BENCH AND BAR SINCE 1888
WWW.NYLJ.COM
An ALM Publication
VOLUME 255—NO. 86
THURSDAY, MAY 5, 2016

White-Collar Crime

Expert Analysis

When Do Business Negotiations Cross the Line and Become Fraud?

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The federal mail and wire fraud statutes are among the most powerful tools of federal prosecutors because they are drafted in broad language designed to reach unanticipated and ever-changing methods of fraud. As Judge Jed Rakoff wrote many years ago, when he was a federal prosecutor, the mail and wire fraud statutes are "our Stradivarius, our Colt 45, our Louisville Slugger, our Cuisinart—and our true love."[1] But the reach of these laws is not unlimited. Courts have rejected mail and wire fraud prosecutions when prosecutors have attempted to criminalize conduct that does not cross the line, albeit blurry at times, between sharp or unethical behavior and outright fraud.[2]

The outer boundary of the mail and wire fraud statutes has recently been tested in the context of arm's length business negotiations. Courts have wrestled with the distinction between aggressive negotiating tactics and criminal fraud schemes. In a recent divided decision in *United States v. Weimert*,[3] the U.S. Court of Appeals for the Seventh Circuit held that the government overreached by applying the wire fraud statute to misstatements about a negotiating position—for example, the lowest or highest price a party to a business deal is willing to accept.

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In this article, we analyze the majority and dissenting opinions in *Weimert* and then discuss cases from the U.S. Court of Appeals for the Second Circuit that likewise address similar situations in which business negotiations have given rise to criminal fraud charges. We also take up the Second Circuit's much discussed decision in *United States v. Litvak*,[4] and suggest that the line between acceptable negotiation and fraud warrants further judicial clarification.

Weimert's Deal

David Weimert was an executive of Investment Directors, Inc. (IDI), a wholly-owned subsidiary of Anchorbank. In the midst of the 2008-09 financial crisis, Anchorbank had a large loan repayment due but was short of cash. In order to avoid a default, the bank directed Weimert to sell IDI's 50 percent interest in a commercial real estate development, Chandler Creek.

Weimert successfully secured two bids for IDI's 50 percent stake in Chandler Creek, and the IDI board of directors ultimately approved a sale of that stake to the Burke Group.

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As part of the deal, IDI paid Weimert a fee that he agreed to use to buy a personal interest in Chandler Creek together with the Burke Group. As a result, Weimert had a conflict of interest: he was both an executive employed by the seller and a buyer in the same transaction. The IDI board was fully apprised of Weimert's conflict of interest. With the advice of counsel, the board waived the conflict.

Although the IDI board was aware of the terms of the transaction, it did not know the facts about exactly how Weimert came to be personally involved in the deal. Weimert told the board that the Burke Group wanted him to have a financial stake in the deal because of his longstanding oversight of the property, and that his personal participation was required to close the deal. But Weimert was not truthful with the board. In fact, the Burke Group did not request Weimert's participation in the deal. Weimert misled the IDI board into believing that the Burke Group had required Weimert to have an interest in Chandler Creek in order for the deal to close.

Weimert was charged with wire fraud on the theory that he had deceived the IDI board so as to obtain a fee and an interest in Chandler Creek. He was convicted at trial.

Seventh Circuit Analysis

A divided panel of the Seventh Circuit reversed Weimert's conviction on the ground that his misrepresentations to the IDI board were not material. The majority reasoned that Weimert merely misstated the Burke Group's negotiation position—namely, that the Burke Group required him to have a personal interest in Chandler Creek. In the majority's view, Weimert's misrepresentation was "a false prediction about how the [Burke Group] would respond to a counteroffer to exclude Weimert's participation." All of the actual terms of the deal, including Weimert's conflict of interest, "were on the table."

The majority acknowledged that misrepresentations about a party's negotiating position would appear to satisfy the materiality requirement for mail and wire fraud. Information about a party's negotiating position "is surely material in the sense that it is capable of influencing another party's decision." Nonetheless, the majority held that deception about a party's negotiating position is not material because "negotiating parties…do not expect complete candor about negotiating positions, as distinct from facts and promises about future behavior." To the contrary, "[d]eception and misdirection about a party's values, priorities, preferences, and reserve prices are common in negotiation." The majority refused to "criminaliz[e] these tactics" without clearer guidance from Congress.

The majority observed that the government's "strongest argument" was that Weimert was working on the deal as an officer of IDI and therefore the IDI board expected him to be honest about all aspects of the Chandler Creek deal—including negotiating positions. Critically, the majority found it "helpful to view the role of Weimert's fiduciary duty as if this were a transaction involving Weimert's own compensation." The majority determined that a corporate officer's fiduciary duty to the company when negotiating his own compensation is "a matter of controversy and divided authority." For example, state law authority holds that a corporate officer may negotiate his own employment contract in an adversarial, arms-length manner.

In light of uncertainty regarding the nature and extent of Weimert's fiduciary duty to IDI, the majority held that Weimert's obligation to be truthful about the Burke Group's negotiation position was not sufficiently clear to support a criminal conviction. The majority invoked the rule of lenity—the principle that ambiguities in the criminal law are construed in favor of the defendant.[5]

The dissent did not take issue with the majority's holding that misstatements about negotiating positions are not material in context of arm's length negotiations among independent parties. But the dissent stated that Weimert was not an independent party, and that the "IDI board had every reason to expect that Weimert would fairly and honestly represent its interests."[6] Unlike a typical negotiation, in which "the parties are aware

that they are solely bargaining with one another," the IDI board "had no reason to believe that it was also negotiating with Weimert."

Materiality

Both the majority and the dissenting opinions rested on materiality—whether Weimert's misrepresentations were sufficiently material to support a conviction. Significantly, neither opinion analyzed Weimert's misrepresentations from a different angle: whether they amounted to a "scheme to defraud" within the meaning of the mail and wire fraud statutes. Under Second Circuit law, in order to prove the existence of a "scheme to defraud," the government must prove a scheme "that depend[s] for [its] completion on a misrepresentation of *an essential element of the bargain*," and not merely a scheme that "cause[s] [its] victims to enter transactions they would otherwise avoid."[7]

The Second Circuit expressed the "essential element of the bargain" principle in the seminal mail fraud case of *United States v. Regent Office Supply*.[8] In that case, the U.S. District Court for the Southern District prosecuted an office supply company because its sales agents made misrepresentations to potential customers that had nothing to do with "the quality, adequacy or price of the goods themselves," but instead related to how the sales agent was referred to the customer—for example, falsely stating that the agent was referred by a mutual friend. The court reversed the company's conviction because the misrepresentations did not "go to the nature of the bargain itself."

More recently, the Second Circuit applied this principle in *United States v. Shellef*,[9] a wire fraud case involving distributors of a highly regulated chemical with ozone-depleting properties, CFC-113. The government imposed a tax on domestic sales of CFC-113 to discourage its use. Foreign sales were exempt. The distributors told their suppliers that the distributors would sell the CFC-113 internationally, but then sold it domestically and failed to pay the required taxes.

The distributors were charged with wire fraud based on what the court called a "no sale" theory: The suppliers would not have sold the CFC-113 to the distributors but for their false representations that it would be sold outside the country. A jury convicted the distributors. The Second Circuit reversed the convictions, in part on the ground that the district court should have dismissed the indictment's "no sale" theory of wire fraud. The court held that the "no sale" theory failed to allege that the distributors "misrepresented the nature of the bargain" or that their deception had "relevance to the object of the contract"—namely, the sale of CFC-113 at a specified price.

Although the Seventh Circuit viewed the facts in *Weimert* in relation to the question of materiality, the facts could also be analyzed through the lens used in *Regent Office Supply* and *Shellef*—whether the deception went to an "essential element of the bargain." In saying that "all terms of the deal were on the table" and holding that Weimert's statements and omissions were not material, the majority could likewise have held, but did not, that Weimert's actions did not go to an essential element of the bargain.

The dissent disagreed with "the majority's conclusion that…the IDI board received what it agreed and expected"—again, discussing the elements of the bargain but in the context of materiality, not fraudulent intent. In short, the Weimert majority's and dissent's analyses centered on the same questions as those in *Regent Office Supply* and *Shellef*, but they invoked different (if closely related) concepts: materiality in *Weimert*, and fraudulent intent and "essential element of the bargain" in the Second Circuit cases.

'United States v. Litvak'

Weimert's materiality analysis and *Shellef's* "essential element of the bargain" analysis came together in *United States v. Litvak*, in which the Second Circuit analyzed misstatements made in the context of negotiating securities transactions. Jesse Litvak was a bond trader at Jefferies. He acted as a broker for buyers and sellers of residential mortgage-backed securities (RMBS). Among other things, the government

alleged that Litvak made fraudulent misrepresentations to the parties who purchased RMBS from Jefferies. Litvak told buyers that Jefferies had acquired RMBS at a higher price than it actually paid, which gave counterparties a false impression about the profits Jefferies was making from the transactions. A jury convicted Litvak of securities fraud.

On appeal, Litvak made arguments like those made in *Weimert* and *Shellef*. First, he argued that "the government's theory of materiality…would raise the specter of criminal liability for commonplace conduct in negotiations."[10] Litvak claimed his misstatements about Jefferies' profits obscured nothing about the RMBS he sold and bought, and he was therefore like "a car salesman who falsely tells a customer that he cannot lower his price any further because he would earn only a miniscule profit."[11] Second, Litvak argued that his misstatements were "irrelevant to the object of the contract: namely, to receive a bond of a certain value at an agreed-upon price."[12]

The Second Circuit reversed Litvak's conviction on account of the district court's exclusion of expert testimony but did not address either of these arguments head on. As to materiality, the court held that the materiality of Litvak's misstatements was a fact issue for the jury because Litvak's counterparties testified that his misstatements were "important" and that they "injured" them.[13]

The court did not address Litvak's argument that false statements about profits were statements about his negotiation position and thus not actionable. To take up Litvak's analogy with buying a used car, suppose someone makes a purchase after hearing a salesperson deceptively talk about his tiny profit margin. The language used by the Second Circuit, taken literally, would permit a prosecution if the salesperson's misleading pitch was "important" to the buyer and caused him "injury" by increasing the purchase price.

The Second Circuit did not address whether Litvak's misstatements distorted an "essential element of the bargain." The Second Circuit side-stepped the issue based on precedent that the "essential benefit of the bargain" principle underlying *Shellef* does not extend to securities fraud, foreclosing Litvak's Shellef argument.[14] The court did not explain why the "essential element of the bargain" principle applies to mail and wire fraud but not securities fraud, or consider whether that distinction raises issues under the rule of lenity.

Conclusion

Litvak shows that the line between aggressive negotiating positions and fraud will remain blurry and very fact specific. It can be difficult to say, in the abstract, when a misstatement concerns a negotiating position as opposed to a deal term. For example, the Second Circuit noted that Litvak's misstatements about Jefferies profits were "embedded in the price" as "agreed-upon mark ups or commissions," and that the price was a heavily negotiated deal term. At the same time, Weimert's materiality analysis and invocation of the rule of lenity may provide a useful guide through very challenging terrain—challenging for defendants, counsel and the courts.

1. Jed S. Rakoff, The Federal Mail Fraud Statute (Part I), 18 Duq. L. Rev. 771, 771 (1980).

2. See, e.g., *United States v. D'Amato*, 39 F.3d 1249 (2d Cir. 1994).

3. 2016 WL 1395180 (April 8, 2016).

4. 808 F.3d 160 (2d Cir. 2015).

5. See generally Antonin Scalia and Bryan Garner, Reading Law: The Interpretation of Legal Texts, at 296-302 (2012).

6. *United States v. Weimert*, 2016 WL 1395180, at *19 (April 8, 2016) (Flaum, J., dissenting).

7. *United States v. Shellef*, 507 F.3d 82, 107 (2d Cir. 2007) (emphasis added).

8. 421 F.2d 1174 (2d Cir. 1970)

9. 507 F.3d 82 (2d Cir. 2007).

10. *United States v. Litvak*, 14-2902-cr (2d Cir.), Brief of Defendant-Appellant at 28.

11. Id. at 30.

12. Id. at 35.

13. *Litvak*, 808 F.3d at 176.

14. Id. at 178-79.