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Labor & Employment Update

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Recovering from Dishonest Employees and Their Accomplices

The Ninth Circuit Court of Appeals recently decided a criminal case which could have ramifications for employers who have had the misfortune of having dishonest employees on the payroll. The case is *United States v. Gamma Tech*, 265 F.3d 917 (9th Cir. 2001). While the facts of the case presented the federal crime of receiving kickbacks in connection with government contracts, the analysis presented in the decision could apply to any other industry, and to other crimes by employees.

The employer was a Navy contractor under an Indefinite Type Delivery Contract. Basically, the employer agreed to perform certain tasks on Navy ships, as needed, under an established pricing agreement per task. The employer priced the tasks at levels which it felt would allow it to complete the work and earn a profit.

To do its job, the employer sometimes needed to hire subcontractors. The principal defendant had been the employer's contracts administrator.

ABOUT THIS UPDATE

Criminal prosecution can produce restitution for an employer, with assistance in collection and without a civil suit.

He awarded the work to the subcontractors and approved their invoices for payment. Obviously, the subcontractors had an incentive to ingratiate themselves with him, a fact which was not lost on the employee. He began demanding kickbacks from the subcontractors, in exchange for assuring that work would be sent their way with faster payment of their invoices.

But the scheme didn't stop there. The competitive bidding process had completely broken down. Contracts were awarded, based not upon price or quality of work but on an agreement to pay the kickbacks demanded. Because the subcontractors could afford to pay larger kickbacks only if

larger and larger invoices were approved for payment, the subcontractors grossly inflated their invoices, which the employee approved for payment. Sometimes the work invoiced was non-existent or double-billed.

It doesn't take an accountant to figure out that this scheme drastically cut into the employer's profit margin. The inflated invoices (and invoices for work never performed) increased the employer's cost of doing business, but the amounts paid by the Navy were fixed by contract. The employer could only make a profit if costs were kept down.

Another simple, but perhaps not so intuitive, reason the scheme cut into the profit margin lies in the fact that a kickback was paid at all. Assume that a particular job is bid by a kickback-paying subcontractor for \$10,000. The understanding is that a \$1,000 kickback to the employee will be paid. That means the subcontractor was willing to do the work for

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\$9,000 (assume, for the sake of this example, that \$9,000 is a fair, non-inflated price for the work to be performed). The \$1,000 difference (the kickback) should have inured to the benefit of the employer, not the employee. Instead, the employer pays \$10,000 for \$9,000 worth of work, and the employee pockets an extra \$1,000. The end result would have been the same as if he had stolen the money from the employer's safe or from a petty cash fund. The employee is, in every sense of the word, a thief.

That's what happened to the employer here. Except that, over time, the losses to the employer totaled nearly \$1 million. The employee was eventually caught and, with some of the subcontractors, was prosecuted in federal court for giving/accepting kickbacks, conspiracy, etc. In the federal system, 41 U.S.C. § 51 *et seq.* makes demanding, offering, giving, accepting, etc. kickbacks on federal contracts or subcontracts, a crime. (In California, the same conduct is criminalized, regardless of whether a public contract is at issue, by California Penal Code § 641.3, "Commercial Bribery.")

The defendants each pleaded guilty to various charges. At their sentencing hearing, the employer appeared through counsel and requested restitution for the losses it had suffered as the victim of the crimes. Not surprisingly, the defendants objected. Then the government took the highly unusual step of siding with the defendants, and actually opposed the victim's request for restitution in order to preserve its plea agreements. The sentencing judge permitted the victim to present evidence. Witnesses were examined. The victim prevailed. Restitution awards of varying amounts were awarded, and the defendants appealed. The government again sided with the defendants on appeal. The employer was permitted to argue in the appeals court as an *amicus curiae*, or "friend of the court."

The appellate court agreed that the sentencing judge had discretion to hear from a victim at sentencing. When deciding the appropriate sentence for a criminal, the judge can take into account virtually anything presented, subject of course to certain constitutional limitations. The fact that the government objected, or that a plea bargain had been worked out between the government and the defendants which did not contemplate restitution, was immaterial.

In state court, the result would be virtually the same. A victim has the right to appear at sentencing and be heard. Penal Code § 1191.1. Further, when a state court plea bargain is entered into, it is common for a defendant to give a *Harvey* waiver: the judge, when imposing sentence, may consider all of the facts

and circumstances, included facts relevant to the charges and conduct for which the defendant was never charged, and may order full restitution regardless of whether the charge was dismissed as to that victim.

The appellate court had no trouble deciding that the losses caused by the inflated invoices were proper amounts for restitution to the employer. The prices charged to the Navy were basically fixed. The only way to make a profit was to keep costs near or below those estimated when bidding the prime contract. The subcontractors and the employee seriously cut into the profit margin by escalating costs.

The appellate court also concluded that the kickbacks paid to the contracts administrator *belonged* to the employer. California Labor Code § 2860 provides:

Everything which an employee acquires by virtue of his employment, except the compensation which is due to him from his employer, belongs to the employer, whether acquired lawfully or unlawfully, or during or after the expiration of the term of his employment.

The employee received the kickbacks while employed and by virtue of his employment. He owed the kickbacks to the employer. Because the subcontractors were co-conspirators, they were jointly and severally liable to the employer for the amounts of the kickbacks that the employee received.

Unfortunately for the employer, the defendants were not advised of the possibility of restitution when they entered their guilty pleas. Thus, their pleas were invalid if the sentencing judge intended to order restitution. They had been advised they could be fined in varying amounts, although no fines were imposed. To the extent that the restitution awards exceeded the maximum possible fines of which the defendants were advised, the court said the error needed to be corrected: either reduce the restitution awards to the maximum fine amount or allow the defendants the opportunity to withdraw their pleas and go to trial.

In the end, the defendants accepted the lower restitution awards of \$500,000 each. The United States Attorneys' Collection Unit and the supervising probation officers are responsible to enforce the awards.

Gamma Tech provides fair warning to employees (and their accomplices) that if they choose to steal from or otherwise inflict harm upon their employers, they could be forced to compensate their victims, even without a civil suit being filed. The decision also provides guidance to employers who uncover dishonest employees and wish to recoup their losses, but without the added expense of a civil suit.

ABOUT THE AUTHORS



Robert D. Rose is a partner in the Business Crimes Practice Group in the firm's San Diego office, where he specializes in white-collar criminal defense and all varieties of civil fraud litigation in the state and federal courts. Mr. Rose was a federal prosecutor for twelve years, followed by the last fifteen years as a defense attorney. He has tried cases as a cross-designated Deputy District Attorney. He has prosecuted organized crime figures, utilizing electronic surveillance, informants, witness protection and grand juries. He was the victim-employer's counsel in *U.S. v. Gamma Tech*.



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Applicability of the legal principles discussed may differ substantially in individual situations. The information contained herein should not be construed as individual legal advice.

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