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Saul Ewing LLP

White Collar and Government Enforcement Practice

White Collar Watch

The Newsletter of the White Collar and Government Enforcement Practice

Contents

SEC Charges Municipal Bond Issuer with Securities Fraud for Misleading Statements on Issuer's Website

By George T. Magnatta and Michael C. Barnes

IN BRIEF

- For the first time, the Securities and Exchange Commission has charged a municipality with securities fraud for misleading statements made outside of the municipality's securities disclosure documents.
- In a report accompanying the release of the charges, the SEC cautioned other public officials that liability could arise for statements that are reasonably expected to reach the investor marketplace, even if not connected to any particular securities offering.

A northeastern city ("City") was recently charged with securities fraud for misleading statements by City officials that were made available to the public on the City's website. These statements were made during a period of time when the City's financial condition was deteriorating and the financial information available to municipal bond investors was either incomplete or outdated.

The charges, filed this month by the Securities and Exchange Commission ("SEC"), mark the first time that the SEC has charged a municipal bond issuer with securities fraud for statements made outside of the issuer's securities disclosure documents.

The SEC explained that its decision to charge the City for these statements was influenced by the City's failure to make its required continuing disclosure filings with the Electronic Municipal Market Access system ("EMMA") (the central repository for information disclosures by municipal bond issuers). By not providing updated financial information to the EMMA website, the City created a risk that investors could purchase or sell securities issued or guaranteed by the City in the secondary market on the basis of incomplete and outdated information, or look to other sources of information supplied by the City, including the City's website.

The City and the SEC agreed to settle the charges. In doing so, the City neither admitted nor denied any wrongdoing, but agreed to cease and desist from further violations. The SEC indicated that, in accepting

the settlement, it took into account the City's cooperation with the investigation and the steps it has taken to improve its disclosure process. In the settlement, the SEC stated the following regarding a municipal issuer's obligations for information that is released to the public:

"Municipal issuers have an obligation to make sure that information that is released to the public that is reasonably expected to reach investors and the trading markets, even if not specifically published for that purpose, does not violate the antifraud provisions . . . . Since access by market participants to current and reliable information is uneven and inefficient, municipal issuers presently face a risk of misleading investors through public statements that may not be intended to be the basis of investment decisions, but nevertheless may be reasonably expected to reach the securities markets."

In a release accompanying the settlement, the SEC advised that statements made by public officials who may be viewed as having knowledge of the financial condition and operations of an issuer should be carefully evaluated to ensure that they are not materially false or misleading. The SEC encouraged municipal issuers to:

- adopt policies and procedures that are reasonably designed to result in accurate, timely and complete public disclosure
- identify those persons involved in the disclosure process
- evaluate other public disclosures that have been made by the issuer prior to the public dissemination of additional information
- assure that responsible individuals receive adequate training about their obligations under federal securities laws.

The SEC also advised that failure to comply with ongoing disclosure obligations may increase the risk that public statements by officials may be misleading or omit material information.

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State v. Brown Affords Managers in the Mortgage Processing Industry a Cautionary Tale

By Christopher R. Hall and Mark A. Simanowith

IN BRIEF

- **Significant jail time can result from overseeing and directing unauthorized robo-signing activities.**
- **Victims of unauthorized robo-signing include residential mortgage servicers, in addition to homeowners.**

On May 2, 2013, Lorraine Brown, former president of DocX, a mortgage document processor, was sentenced to 40 months to 20 years in prison on one count of racketeering in connection with the "robo-signing" of mortgage documents filed in Michigan (*State v. Brown*, Mich. Dist. Ct., No. 96-12901909-01). Brown pleaded guilty in February to the charge. Her conviction followed an Attorney General investigation into questionable mortgage documentation filed with Michigan's Register of Deeds from 2006 through 2009.

The Michigan Attorney General ("AG") launched the investigation in April 2011 after a "*60 Minutes*" news broadcast prompted concerns with county officials across the state that certain mortgage documents filed in their offices may have been forged.

County officials in Michigan reviewed their files and found documents that appeared to have variations in handwriting, resulting in questions about the authenticity of the documents.

During the investigation, the AG's office reviewed documents prepared by DocX. The majority of DocX's clients were residential mortgage servicers for whom DocX would, among other things, accept and record mortgage payments, pay taxes and insurance from borrower escrow accounts, and conduct or supervise the foreclosure process. From at least March 2003 through November 2009, Brown marketed DocX as an outsourcing solution to mortgage servicers for filing and recording mortgage documents throughout the United States. In exchange for this service, DocX was paid $5 to $15 per document. Between 2003 and 2009, DocX generated approximately $60 million in gross revenue.

The AG's investigation revealed that, instead of having an authorized person properly review the documents filed on behalf of her clients and flag for correction any incomplete or unsigned mortgage documents, Brown directed employees to forge and falsify signatures on unexecuted documents so that DocX could file and record mortgage documents more quickly, resulting in greater revenue for DocX. DocX internally referred to this practice as "facsimile signing" or "surrogate signing." The AG's investigation further revealed that more than 1,000 unauthorized and improperly executed documents were created and recorded at Brown's direction throughout Michigan.

Brown has agreed to plead guilty to similar charges in Missouri and Florida. Based on documents filed in those cases, it is estimated that, between 2003 and 2009, DocX filed over one million documents with forged signatures across the nation.

Second Highest Penalty in FCPA History Comes with a Caution from the Bench about the Limits of the Act's Jurisdiction

By Christopher R. Hall and Jennifer L. Beidel

IN BRIEF

- **The Foreign Corrupt Practices Act covers a nearly boundless range of business conduct by issuers and their agents in an ever more global world. Yet the contrast in sentences handed down in two recent FCPA cases illustrates the limits of this law. The concept of "minimum contacts" acts as a restraint on prosecution, even if only for foreign nationals.**

A $100 million bribery scheme and cover-up involving Siemens AG has resulted in very different outcomes for two company officials who faced charges under the Foreign Corrupt Practices Act ("FCPA"). Former Siemens AG Managing Board Member Uriel Sharef must pay a $275,000 civil penalty for his conduct, the second largest penalty ever assessed in a case involving the FCPA. The other, Siemens Argentina CEO Herbert Steffen, had all claims against him dismissed.

At the crux of these contrasting rulings – both handed down this year by United States District Judge Shira A. Scheindlin – was prosecutors' ability to establish whether the Siemens officials, who are both foreign nationals, had "minimum contact" with the United States government in their dealings. These divergent results provide an opportunity to assess the role that "minimum contacts" play in a determination of FCPA exposure for individuals subject to scrutiny by the Securities and Exchange Commission ("SEC") and Department of Justice.

Siemens was subject to such scrutiny when, after bribing Argentine officials in a decades-long scheme to retain a government contract to produce national identity cards, the company made false certifications in its SEC filings to cover up its actions. These certifications were required by the Sarbanes-Oxley Act.

In determining whether it could assert jurisdiction in each Siemens official's case, the District Court had to find "certain minimum contacts with [the United States] such that the maintenance of the suit does not offend traditional notions of fair play and substantial justice." *U.S. Sec. & Exch. Comm'n v.*

Sharef, 11 Civ. 9073, at 11 (S.D.N.Y. Feb. 19, 2013). Minimum contacts can be established when:

(1) the defendant has "followed a course of conduct directed at" the jurisdiction of the United States,

(2) the effects in the United States occur "as a direct and foreseeable result" of the extraterritorial conduct, and

(3) the defendant knows or has good reason to know that his conduct will result in the United States asserting jurisdiction over him.

Even if this standard is satisfied, other factors may make the exercise of jurisdiction unreasonable, including the burden on the defendant and the interests of the United States in obtaining relief.

The District Court found sufficient facts to support "minimum contacts" as to Sharef, but not as to Steffen. Sharef had recruited Steffen "to facilitate the payment of bribes" to Argentine officials. Steffen then met with the CFO of the Siemens operating group that was to pay the bribes to "pressure" him to authorize bribes, and participated in one phone call with Sharef to urge Sharef to make additional payments in response to demands from the Argentine government. But the CFO of the Siemens operating group would not pay the bribes until he spoke with several "higher ups," above Steffen, like Sharef, and deemed Sharef's response as his instructions to bribe. The CFO then instructed numerous subordinates to generate a series of fictitious documents to facilitate the payments and to obscure the audit trail. The District Court attributed this conduct to Sharef's order to the CFO.

In contrast to Sharef, Steffen did not engage in the production of the fictitious documents that supported the false certifications, and Judge Scheindlin found that Steffen's actions were "far too attenuated from the resulting harm to establish minimum contacts" with the United States. The District Court acknowledged that Steffen "urged" and "pressured" the CFO to pay the bribes, but placed substantial weight on the fact that the CFO had only agreed to proceed after receiving instructions directly from several other "higher ups," including Sharef. The District Court viewed Steffen's involvement as merely tangential to the subsequent cover-up via the false SEC filings and supporting fictitious documents.

Judge Scheindlin expressed concern that jurisdiction could extend to anyone allegedly involved in a bribery scheme "no matter how attenuated their connection with the falsified financial statements" if she asserted jurisdiction over Steffen. "If this court were to hold that Steffen's support for the bribery scheme satisfied the minimum contacts analysis, even though he neither authorized the bribe, nor directed the cover up, much less played any role in the falsified [securities] filings, minimum contacts would be boundless," she said.

Novel Trademark Counterfeiting Count Nixed

By Sarah F. Lacey

IN BRIEF

- **Where goods bearing a genuine trademark are altered and resold without altering the mark itself, such conduct does not constitute trafficking in counterfeit goods. Actual use of a counterfeit mark is a necessary element of the offense under federal law.**

Intellectual property crime takes numerous forms, including trafficking in counterfeit goods and counterfeit labeling. The use of fake or altered trademarks is a common problem that can be addressed under both the criminal and civil laws, as there is significant overlap between the two in this context. Surprisingly, however, the use of a genuine trademark on altered goods does not create criminal liability under current federal law. The Fourth Circuit recently held that where goods bearing a manufacturer's genuine trademark are altered and resold without altering the mark itself, such conduct does not constitute trafficking in counterfeit goods under the Trademark Counterfeiting Act, 18 U.S.C. § 2320(a). *United States v. Cone*, Nos. 11-4888, 11-4934, 2013 WL 1502007 (4th Cir. Apr. 15, 2013).

United States v. Cone

Cone concerned a conspiracy to import and resell sophisticated computer networking equipment manufactured by Cisco Systems, Inc. ("Cisco"). Defendant Chun-Yu Zhao and her co-defendant, Donald Cone, operated JDC Networking, Inc. ("JDC") as a licensed distributor of Cisco products. Cisco prohibits its licensed distributors from purchasing Cisco products outside the United States for resale within the United States. From 2004 through 2010, however, JDC imported from China and Hong Kong more than 200 shipments of counterfeit equipment as well as genuine Cisco equipment. JDC sold the imported equipment to resellers and to consumers at a significant markup over the low prices it paid for the products by purchasing them outside the United States.

Zhao and Cone were convicted on several counts of conspiracy and trafficking in counterfeit goods and labels, importation and sale of improperly declared goods, and wire fraud based on their operation of JDC. The objects of the trafficking conspiracy, according to the government, were threefold:

(1) the sale of "pure" counterfeit products, which were never made with Cisco's authorization;

(2) the sale of relabeled or mislabeled Cisco products; and

(3) the sale of legitimate Cisco products that Zhao and Cone converted into different Cisco products but without altering the original labels (the "material alteration" theory).

The Fourth Circuit agreed with the District Court that the first two theories satisfied all the elements of criminal trafficking. The court rejected the material alteration theory, however, and vacated Zhao's conviction for the underlying offense. The case was remanded for resentencing as to both defendants.

Section 2320 requires proof that the defendant "(1) trafficked . . . in goods or services; (2) did so intentionally; (3) used a counterfeit mark on or in connection with such goods and services; and (4) knew the mark was counterfeit." *United States v. Lam*. A mark is counterfeit under Section 2320 if it is a "spurious mark," meaning it is "identical with, or substantially indistinguishable from, a [registered] mark . . . the use of which is likely to cause confusion, to cause mistake, or to deceive." The Lanham Act's definition of counterfeit is similar to the definition of counterfeit in Section 2320. The government therefore urged the Fourth Circuit to apply civil precedents holding that a genuine mark transforms into a counterfeit mark when the *product* to which the genuine mark has been applied is altered without authorization.

The Fourth Circuit, however, recognized that in the civil context, "'the important test is whether the practice of the defendant is likely to cause confusion, *not whether the defendant duplicated the plaintiff's mark.*'" *Westinghouse Elec. Corp. v. General Circuit Breaker & Elec. Supply, Inc.* By contrast, Section 2320 makes duplication or alteration of the genuine mark an element of the offense, which the court could not ignore even if material alteration would support a finding of civil liability. Moreover, the appellate court emphasized that unlike the Lanham Act, Section 2320 contains an exception for authorized use. Under that exception, a spurious mark does not include a mark that the manufacturer was authorized to use at the time the goods were manufactured. Because criminal statutes must be narrowly construed, these distinctions between the civil and criminal laws were critical to the Fourth Circuit's holding.

Notes for Practitioners

Combating intellectual property ("IP") crime is currently a high priority for the Department of Justice ("DOJ"), the Department of Homeland Security ("DHS") and several federal agencies and task forces. In 2012, DOJ brought 178 cases and DHS brought 334 cases related to IP crimes. DHS seized more than $1.26 billion in counterfeit and pirated goods, as measured by manufacturer's suggested retail prices ("MSRP"). With the rapid increase in IP crime facilitated through the Internet and the current administration's focus on increasing IP enforcement, it is likely these statistics will increase in 2013. Civil efforts to stem counterfeiting are also likely to increase as the economic impact of counterfeiting continues to grow.

Given the government's heightened focus on combating IP crime, both criminal and civil practitioners should be aware of the parallels between civil and criminal IP laws. *Cone* illustrates that there are gaps between those laws that create opportunities for the defense where the government's theories are based on civil standards. Trademark owners also should take note and implement a strategy to routinely monitor unauthorized use of their brands. Where authorized use becomes unauthorized but without alteration of the owner's

genuine mark, only civil remedies may be available to stop infringement or obtain compensation for the unauthorized sales.

Defense practitioners in particular should be aware that penalties for trafficking in counterfeits are stiff. As currently in effect, Section 2320 provides penalties for first-time individual offenders of up to 10 years in prison and a $2 million fine, or for a corporation or other entity, up to a $5 million fine. The penalties and fines for repeat offenders are substantially higher. In addition, a defendant can be ordered to pay restitution to anyone directly or proximately harmed by the defendant's conduct. If measured by the MSRP of the goods and a 1:1 substitution ratio between counterfeit and genuine goods is assumed, the total restitution can be staggering. As civil practitioners are aware, however, a 1:1 substitution ratio can be difficult to prove. While not addressed in *Cone*, practitioners should keep informed of developments in this area.

Health Care Fraud Conviction Stands Despite Vague Standards of Care

By Jennifer A. DeRose

IN BRIEF

- **A failure to meet medical standards, by itself, would not sustain a health care fraud conviction.**
- **The government, however, typically offers additional evidence sufficient to establish knowledge that treatment rendered was neither reasonable nor medically necessary, and therefore, fraudulent.**

The Fourth Circuit recently clarified the *mens rea* requirement in health care fraud prosecutions: even when treatment standards are unclear and diagnostic practice highly subjective, the court will sustain a conviction if the evidence shows the defendant *knowingly* submitted fraudulent claims. *United States v. McLean.*

In this case, a quality control review revealed that Dr. John R. McLean, an interventional cardiologist, placed stents in coronary arteries with no significant blockage in approximately half of 25 randomly selected cases. McLean also grossly overstated the level of blockage in his patients, often recording blockages of 80 percent to 95 percent for lesions of no more than 10 percent to 30 percent. Finally, a government expert testified that it was generally accepted in the medical community that coronary artery stents were not necessary absent at least 70 percent blockage and symptoms such as chest pain or a positive stress test.

McLean countered with a defense expert who testified that elective stents were considered medically appropriate if a patient had at least 50 percent blockage. Further, Medicare's own guidelines did not espouse the prosecution's 70 percent standard but rather emphasized the importance of the physician's judgment in determining whether a stent placement would be appropriate. McLean also offered studies that revealed variations between 15 percent and 45 percent in assessments of blockage by different observers. Finally, McLean presented evidence that he stented only 16 percent of the patients in his practice, and that 85 percent of the stents he implanted were appropriate.

McLean argued that he could not be found to have the necessary degree of *scienter*, or specific intent, to commit health care fraud on these facts because specific intent has two elements: knowledge of a standard, and a knowing violation of the standard. In his subspecialty, McLean contended, the medical community had not agreed upon a standard for when to intervene with stents. He, therefore, could not have possessed the requisite *mens rea*, or *scienter*, to commit health care fraud. His errors were malpractice at worst, not criminal.

The argument failed to persuade the Fourth Circuit. The court started with the premise that a statute is not unreasonably vague when an ordinary person would understand that the conduct at issue was not permitted. As applied to McLean, the

federal health care fraud statute prohibited the false certification of treatment as reasonable and medically necessary. The court concluded that the evidence was sufficient to support a finding of guilt beyond a reasonable doubt that McLean knew the stent procedures were not medically necessary and lied to insurers about his judgment. Thus, far from being an obstacle to the determination of guilt as McLean had proposed, the law's *scienter*, or specific intent requirement, served to cut through the ambiguities of the medical standard and the inherent subjectivity of the diagnostic process. In short, the evidence showed McLean had rendered treatment he knew was wrong.

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