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Contacts:

Christopher R. Hall
Chair

Nicholas J. Nastasi
Vice Chair

Patrick M. Hromisin
Newsletter Editor

Jennifer A. DeRose
Contributor

Keith R. Lorenze
Contributor

Andrea P. Brockway
Contributor

Saul Ewing LLP

White Collar and Government Enforcement Practice

White Collar Watch

The Newsletter of the White Collar and Government Enforcement Practice

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FDIC filing more suits against officers and directors of failed financial institutions

By Jennifer A. DeRose

IN BRIEF

- Prosecutions are up from two in 2010 to 32 so far this year.
- Executives are now named in more than three-quarters of suits and are being held personally liable for damages.

Banking industry executives should take note: this year the Federal Deposit Insurance Corporation has increased yet again the number of civil lawsuits it is filing against the directors and officers of financial institutions that failed during the recession. The rate at which the suits are being filed by the FDIC has been steadily increasing: two in 2010, 16 in 2011, 26 in 2012, and 32 in just the first eight months of 2013. The FDIC is bringing suit against officers and directors in their individual capacity, holding them personally liable for damages allegedly sustained by the financial institutions under their management or oversight. Chief executives, inside directors, and outside directors were named defendants in more than three-quarters of the FDIC suits, but other officers including chief credit officers, chief financial officers, and chief operating officers were also named as defendants in some instances.

While defendants in these suits face civil, not criminal, penalties, the potential financial liability imposed is often crippling. In 2013, for suits in which a damages amount was specified, the average damages claim was for $33 million; in 2012, the average claim was $59 million. Unsurprisingly, with such large verdicts at stake, most defendants have settled out of court. The government may be relying on the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), rather than attempting to bring criminal actions, to take advantage of the lower "preponderance of the evidence" standard of proof in civil suits. In criminal actions, a defendant's wrongdoing must be proved "beyond a reasonable doubt."

While the facts of these cases vary, the claims raised are quite consistent. All 32 lawsuits filed so far in 2013 have claimed damages from the officers' and directors' alleged gross negligence, pursuant to section 1821(k) of FIRREA. This once-obscure statute makes bank executives personally liable for loss or damage at their institutions caused by their gross negligence. The statute empowers the FDIC to pursue additional claims against officers and directors, including "conduct that demonstrates a greater disregard of a duty of care (than of gross negligence) including intentional tortious conduct" and allows the FDIC to bring claims under a higher standard of care, such as simple negligence, if permitted by state law. This last wrinkle, allowing state law claims for negligence, has created an additional layer of uncertainty as these cases move through courts of different jurisdictions.

Officers and directors of financial institutions – like other corporate officers and directors – have generally enjoyed the protection of the business judgment rule, shielding them from personal liability for ordinary negligence. However, where the FDIC has brought state law negligence claims alongside claims of gross negligence under FIRREA, federal courts have applied state law regarding the business judgment rule in varying ways. A recent decision from the Northern District of Georgia, now on appeal to the Eleventh Circuit, held that Georgia's business judgment rule stood as a bar to simple negligence claims against officers and directors, and dismissed the FDIC's negligence claim. Meanwhile, the Northern District of Illinois and the Eastern District of North Carolina have both denied motions to dismiss such negligence claims, declining to consider the state business judgment rule at the motion to dismiss phase and allowing the negligence claims to go forward to trial. Given the sizeable damages awards that the FDIC seeks in these cases, it seems likely that most defendants will avoid these uncertainties by settling out of court.

Third Circuit upholds 12-year prison sentence for former BigLaw associate

By Keith R. Lorenze

IN BRIEF

- **Sentence thought to be the longest prison term for an insider trading case against an individual who pleaded guilty.**
- **Ruling illustrates the Circuit Court's deference to the trial court's sentencing procedures.**

A federal appeals court recently affirmed what is reportedly the longest prison sentence ever meted out to an individual who pleaded guilty to charges of insider trading. The Third Circuit's July 9, 2013 decision in *United States v. Kluger*, 722 F.3d 549 (3d Cir. 2013), however, is noteworthy not only for the length of the sentence that was upheld, but also for the identity of the defendant: Matthew Kluger, a 1995 graduate of New York University School of Law, and formerly a summer associate at the law firm of Cravath, Swaine & Moore and an associate at the firms of Skadden Arps, Fried Frank, and Wilson Sonsini. Kulger's appeal challenged the 12-year prison sentence he received from District Judge Katharine S. Hayden following his guilty plea. The reasons behind the Third Circuit's rejection of Kluger's challenges to his sentence provide valuable insight into the deference the Circuit Court will show to the District Court's sentencing procedures and decisions.

Background

On April 5, 2011, the government charged Kluger with securities fraud, conspiracy to commit securities fraud and other related charges. The insider-trading conspiracy with which Kluger was charged consisted of only three participants – Kluger, Kenneth Robinson and Garret Bauer – but "spanned 17 years" and, to date, "constituted the longest such scheme in United States history," according to court documents. Kluger was charged with passing material, nonpublic information to Robinson concerning mergers and acquisitions that he obtained, first in his capacity as a summer associate, and then, subsequently, as an associate at the various law firms where he was employed. Robinson then conveyed that information to Bauer, a professional stock trader, who used it to execute trades on behalf of, and for the benefit of, the three conspirators.

On December 14, 2011, Kluger entered a guilty plea with the District Court pursuant to a plea agreement that did not contain a stipulation for his sentencing guidelines range. Following the conclusion of a sentencing hearing, the District Court sentenced Kluger to a term of 12 years in federal prison, which, as the Third Circuit ruling noted, is "thought to be the longest insider-trading sentence ever imposed." Robinson, the so-called "middleman" in the conspiracy, received a 27-month sentence after pleading guilty to similar charges. Bauer, who executed the trades, entered a guilty plea and received a sentence of nine years in prison.

Kluger's appeal

In his appeal, Kluger challenged, among other things, the District Court's calculation of his sentencing guidelines range and its failure to hold an evidentiary hearing prior to imposing his sentence, as well as the sentence itself, on both procedural and substantive grounds. The Third Circuit rejected each of Kluger's challenges.

First, Kluger argued that the District Court improperly attributed all of his co-conspirators' gains to him, even though, according to Kluger, he did not share in all such gains because Bauer engaged in trades above and beyond the limits to which Kluger had supposedly agreed. Relying on the plain language of the commentary to section 2B1.4 of the Sentencing Guidelines, the Third Circuit held that the District Court properly considered all of Bauer's gains as attributable to Kluger, even to the extent that Bauer did not share them with Kluger. Bauer was a "person acting with the defendant," as well as one "to whom the defendant provided inside information," the ruling stated.

Second, Kluger contended that the District Court erred in failing to hold an evidentiary hearing, during which he would have presented evidence in support of his position that not all of the gains Bauer obtained from the insider trading activities could be attributed to him. The Third Circuit disagreed. Neither the federal Sentencing Guidelines nor the Federal Rules of Criminal Procedure required the District Court to conduct an evidentiary hearing. Rather, the District Court was merely required, according to the court documents, to "provide a procedure – but not necessarily an evidentiary hearing – in which the parties may argue contested sentencing issues;" the District Court satisfied that obligation by providing an "extensive sentencing hearing."

Finally, the Third Circuit upheld the sentence imposed by the District Court on both procedural and substantive grounds. It determined that the District Court, as a matter of procedure, "engaged in a thorough discussion of the 'circumstances of the offense'" and "addressed 'the history and characteristics of the defendant,'" which reflected a "rational and meaningful consideration of the factors enumerated in 18 U.S.C. § 3535(a)." The Third Circuit also found no substantive basis for vacatur. It noted in its ruling that, as a preliminary matter, a sentence that falls within the sentencing guidelines, as was the case here, is "less likely to be unreasonable than a sentence outside the range." The problem with Kluger's argument, according to the Third Circuit, was that it failed to address the sentencing enhancement for "abusing his position of trust as an attorney and did not perform a commensurate level of community service pre- and post-arrest as did Bauer," which justified the imposition of his "mid-range sentence." Thus, the Third Circuit found Kluger's sentence to be both procedurally and substantively reasonable.

Lessons learned from *Kluger*

The *Kluger* case provides several key takeaways regarding sentencing in white collar prosecutions. Focusing on the nature of the client's alleged involvement in the crime may be more persuasive than arguing he tried to limit the scope of his participation with co-conspirators. In addition, white collar practitioners should present objections to the pre-sentence investigation report at the sentencing hearing and be aware that clients who are attorneys may face stiffer penalties if their actions represent a violation of their professional oath.

Health care executives should heed recent trend of significant prison sentences for Medicare fraud convictions

By Christopher R. Hall and Andrea P. Brockway

IN BRIEF

- **A recent case from the Southern District of Florida demonstrates the potential individual exposure of executives convicted of health care fraud to lengthy prison sentences. (*United States v. Kallen-Zury*, S.D. Fla., No. 1:12-cr-20757, sentencing September 10, 2013).**
- **U.S. District Judge Jose Martinez sentenced three executives of a Miami mental health care hospital, Hollywood Pavilion LLC, to prison terms ranging from 12 to 25 years. For the 60-year-old CEO, who received the most lengthy term, this amounts to an effective life sentence.**

Hollywood Pavilion is a 50-bed inpatient facility in Hollywood, Florida, licensed by the state as an adult psychiatric hospital. In October 2012, the Department of Justice charged individual executives of Hollywood Pavilion with a scheme of fraudulent billing and kickbacks, as part of a crackdown on Medicare fraud cited by Attorney General Eric Holder as one of the largest ever. On September 10, 2013, Karen Kallen-Zury, the former CEO of Hollywood Pavilion, was sentenced to 25 years in prison; Daisy Miller, the former inpatient clinical director of Hollywood Pavilion, was sentenced to 15 years in prison; and Christian Coloma, the former director of physical therapy for an entity associated with Hollywood Pavilion, was sentenced to 12 years in prison. In response to the sentencing, Kallen-Zury's attorney cited excessive guidelines and observed how "unfair and draconian the guidelines calculations can be in Medicare fraud cases where so-called loss drives the guidelines score and is measured by amounts billed, ignoring whether there was any harm."

In addition to their prison terms, Kallen-Zury and Miller were ordered to pay more than $39 million in restitution, jointly and severally with certain co-defendants. Coloma was ordered to pay more than $20 million in restitution, jointly and severally with certain co-defendants. The sentencing hearing for Michele Petrie, the former head of Hollywood Pavilion's intensive outpatient program, is scheduled for December 18, 2013.

"These defendants from Hollywood Pavilion who were sentenced . . . are the first executives from a licensed state hospital prosecuted by the Medicare Fraud Strike Force," said Acting Assistant Attorney General Mythili Raman. The Medicare Fraud Strike Force is part of the Health Care Fraud Prevention and Enforcement Action Team (HEAT), which was created in May 2009 by the Department of Health and Human Services (HHS) and Department of Justice (DOJ). According to Raman, the defendants "abused the public's trust by deliberately targeting disabled substance abusers and conning them into spending weeks locked down at a psychiatric hospital. Their conduct proves that health care fraud is not only about harm to the public fisc – it is about real harm to individuals in need of medical care."

In June 2013, a federal jury convicted Kallen-Zury, Miller and Petrie of various counts of wire fraud, health care fraud and conspiracy to commit fraud for their roles in the fraudulent billings scheme run out of Hollywood Pavilion. Kallen-Zury, Miller, Petrie and Coloma were also convicted of one count of conspiracy to pay bribes in connection with Medicare, with Kallen-Zury and Coloma also each being convicted on five substantive counts of paying bribes.

Evidence at trial demonstrated that the defendants paid illegal bribes and kickbacks to patient recruiters in order to obtain Medicare beneficiaries as patients who did not qualify for psychiatric treatment. Many of the recruiters were convicted felons. The recruiters were collectively paid more than $1 million for the patient referrals. The defendants then submitted claims to Medicare for those patients who were procured through bribes and kickbacks.

The evidence also showed that Kallen-Zury attempted to conceal the payment of bribes and kickbacks by creating false documents to make it appear as if legitimate services were being rendered. Miller and Petrie facilitated the payment of bribes to patient recruiters and oversaw the fraudulent admissions and treatment of unqualified patients. Coloma facilitated the payment of bribes and kickbacks, and he supervised the creation of false documents to conceal the bribery scheme.

Given the success of the Medicare Fraud Strike Force's first action against individual executives, it is reasonable to expect that they may focus on them in the future. Saul Ewing's *White Collar Watch* has discussed the liability of individual executives in the past (Please see http://www.saul.com/publications-alerts-1037.html), and this is a new avenue for the government to pursue such actions. Saul Ewing's White Collar group will monitor these developments and update you in the future.

Update: J.P. Morgan settlement shows SEC's increasing strictness

The Securities and Exchange Commission is already demonstrating the stricter approach to settlements that Saul Ewing wrote about in the last issue of the firm's *White Collar Watch*. (See http://www.saul.com/media/site_files/3650_WCW082313.pdf) Just this month, the SEC entered into a settlement agreement with J.P. Morgan, which agreed to pay more than $920 million in connection with its conduct in the "London Whale" matter. In addition to the financial penalty relating to a series of allegedly improper trades carried out by a J.P. Morgan employee in 2012, J.P. Morgan was forced to admit wrongdoing. In an interview with the *Wall Street Journal* on September 20, 2013, Duke University law professor James Cox noted that the "settlement has an awful lot of language that we've not seen in an SEC settlement in decades." As we pointed out in the last issue, such settlement agreements are likely to become increasingly common under the SEC's new approach.

The Saul Ewing White Collar and Government Enforcement Practice

Christopher R. Hall, Chair
215.972.7180
chall@saul.com

Nicholas J. Nastasi, Vice Chair
215.972.8445
nnastasi@saul.com

Jennifer L. Beidel
215.972.7850
jbeidel@saul.com

Andrea P. Brockway
215.972.7114
abrockway@saul.com

Brett S. Covington
202.295.6689
bcovington@saul.com

Jennifer A. DeRose
410.332.8930
jderose@saul.com

Cathleen M. Devlin
215.972.8562
cdevlin@saul.com

Justin B. Ettelson
215.972.7106
jettelson@saul.com

Patrick M. Hromisin
215.972.8396
phromisin@saul.com

Keith R. Lorenze
215.972.1888
klorenze@saul.com

Timothy J. Lyon
412.209.2516
tlyon@saul.com

David R. Moffitt
610.251.5758
dmoffitt@saul.com

Joseph F. O'Dea, Jr.
215.972.7109
jodea@saul.com

Amy L. Piccola
215.972.8405
apiccola@saul.com

Christine M. Pickel
215.972.7785
cpickel@saul.com

Courtney L. Schultz
215.972.7717
cschultz@saul.com

Gregory G. Schwab
215.972.7534
gschwab@saul.com

Nicholas C. Stewart
202.295.6629
nstewart@saul.com

Chad T. Williams
302.421.6899
cwilliams@saul.com