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Civil Or Criminal Securities Fraud — A Blurry Line

Law360, New York (October 17, 2008) -- There are undoubtedly securities fraud cases in which jurors would feel compelled to award money based on the wrongdoing, while feeling hesitant to attach both the stigma of a criminal conviction and the potential for imprisonment to their findings.

Nevertheless, some scholars have opined that the only meaningful differences between civil fraud and criminal fraud are the particular procedures and rules that attach to each type of proceeding and sanction.

The roles and views of outside professionals – both those who participated in the underlying events and those who serve as expert witnesses at trial – can reduce culpability, or the perception of culpability, for an offense such that it may warrant only a financial penalty.

For example, jurors' perceptions of the degree of a defendant's culpability might be influenced by evidence that certain outside professionals did not or do not view the defendant's conduct as unreasonable or inappropriate.

Practitioners should consider various ways in which the role of outside professionals and related jury instructions can help jurors draw the line between civil fraud and criminal fraud in a favorable way.

A pending criminal case sheds light on some of the challenges facing defense attorneys in securities fraud matters, including the inconsistent treatment of outside professionals by courts.

On Oct. 1, 2008, a federal criminal trial began in Columbus, Ohio, to determine whether Lance Poulsen participated in a fraud that caused investors and others, by some accounts, more than \$3 billion in damages.

Poulsen co-founded National Century Financial Enterprises, commonly referred to as NCFE, one of the largest healthcare financing companies ever operated in the United States.

Before its collapse, NCFE purchased accounts receivables from a variety of healthcare providers. NCFE raised the funds for these purchases through the offer and sale of program notes issued by subsidiaries.

The criminal charges focus on alleged misrepresentations to investors regarding the quality of receivables purchased, as well as the diversion of funds for impermissible purposes.

Several NCFE employees have already been convicted of criminal fraud, which carries with it collateral estoppel implications for future civil cases.

A question that arises is how the roles of outside professionals in Poulsen's case might affect the determination of whether he was merely a participant in civil fraud, rather than criminal fraud.

Two recent orders of the federal court in the Poulsen matter provide examples of the varying roles of outside professionals in criminal securities fraud proceedings.

Prior to trial, Poulsen filed a motion to dismiss all criminal charges pending in the indictment against him. He argued unsuccessfully that the government withheld exculpatory material such as documents pertaining to civil findings by the SEC regarding the involvement of various accounting firms, investment banks, and rating agencies in the debacle.

He theorized that he relied on these outside professionals at the time of his allegedly criminal conduct, and that they failed to perform their duties, which minimized any showing of his intent to commit fraud.

In an order dated Sept. 22, 2008, the court concluded that, "even if the SEC documents demonstrate that NCFE's auditors and other reviewers admitted negligence in their review of NCFE's operating procedures, this evidence is at best only tenuously exculpatory given the scope of Defendant Poulsen's alleged involvement in NCFE's alleged fraud."

In so doing, the court may have foreshadowed its limited tolerance for detours at trial into certain conduct of outside professionals that occurred at the time of the alleged wrongdoing by Poulsen and his alleged co-conspirators.

On the same day, the court issued a second order regarding certain evidentiary matters at trial. Among its rulings, the court denied, with a very limited exception, the government's motion to preclude expert testimony on which Poulsen intended to rely at trial.

Categories of such expert testimony included “showing that the collapse of NCFE and the NPF programs in 2002 was attributable to third party outsiders,” the “interpretation of the draft audit” submitted to NCFE by an outsider auditor, and the permissibility of the suspect receivables purchases based on an interpretation of “the governing documents and the receivables allegations and data.”

Essentially, and somewhat counterintuitively, in this pair of orders the court suggested a greater willingness to hear from outside professionals as expert witnesses, who are paid to opine after-the-fact on the totality of circumstances, than to hear factual testimony regarding any actual reliance by Poulsen on the outside professionals involved in the business at the relevant time.

In certain ways, reliance on paid experts at trial can be safer than the traditional reliance on professionals defense. A “reliance on counsel” defense, for example, generally requires a defendant to produce evidence that he fully informed his counsel of the relevant facts, received advice from that counsel, and reasonably followed it in good faith.

In both civil and criminal cases, most courts strictly impose on defendants the burden of production as to each of these elements. Some courts have even imposed the burden of persuasion on defendants to establish a reliance on professionals defense, particularly in civil cases.

Unlike the typical good faith reliance defense, the use of retained experts at trial can provide opinions to the jury that tend to excuse defendants for their roles in events, without necessarily opening the door to every piece of evidence that suggests other than good faith conduct by the defendant.

When a defendant raises a reliance on professionals defense, courts may allow government attorneys to introduce a wide array of evidence tending to show that the defendant could not have relied on the particular professional(s) in good faith.

When formulating and explaining their opinions, retained experts can rely on the same participation, statements, and omissions by the outside professionals who participated in relevant events, opining on their significance, without so clearly opening the door to bad evidence or triggering the same evidentiary burdens as would a reliance defense.

There is a potential irony in the Poulsen court’s rulings with respect to outside professionals.

One interpretation of the Sept. 22 orders is that the court has made the opinions of outside professionals who serve as paid after-the-fact experts, sometimes colloquially referred to as hired guns, more important than what outside professionals did and thought during the actual underlying events.

At trial, much more focus may be drawn to the retained experts than to those professionals with whom Poulsen actually interacted at the time of the conduct at issue.

Defense counsel must be alert to the potential that both types of outside professionals have to contribute to a jury viewing the defendant as not quite culpable enough for a conviction.

Where available, counsel must be able to use each kind of outside-professional evidence and must adjust based on, among other things, the doors that use of professionals will open and barriers set up by the court's perceptions and rulings with respect to the role outside professionals can play at trial.

Poulsen's expert witnesses face serious challenges. A jury has already convicted Poulsen of obstruction of justice arising from his interaction with a witness, former NCFE employee Sherry Gibson.

While Poulsen's sentence of 10 years' imprisonment on his obstruction conviction is not likely to reach the jury, the obstruction offense by itself is highly incriminating. In its Sept. 22, 2008 Order, the court has ruled that Poulsen's conviction for obstruction can be used against him at the criminal fraud trial to help the government prove Poulsen's consciousness of guilt.

With the Poulsen court possibly signaling a low tolerance for evidence concerning Poulsen's interaction with outside professionals during the events at issue, a defense theme that distinguishes between civil and criminal wrongdoing, through expert witnesses and jury instructions, may offer the only glimmer of hope for defendants in a position similar to Poulsen.

His obstruction of justice conviction has been deemed relevant by the court to show his consciousness of guilt on the pending charges. Co-conspirators will likely testify and admit the commission of fraud.

Defense counsel may lose points with a jury by failing to acknowledge at least the applicability of civil remedies. Expert testimony might help a jury find that, even if a fraud occurred, the sanction should be civil rather than criminal.

While there may be little precedent for a criminal jury instruction expressly distinguishing between civil fraud and criminal fraud, several customary instructions offer an opportunity for helpful additional language that could support a defense theme that makes that distinction.

Trial lawyers can agonize over slight changes to the model jury instructions to which courts may turn, or the aggressive suggestions by prosecutors.

One area in which to agonize is the instruction regarding experts, which could have implications for both retained experts and outside professionals. There are familiar jury

instructions regarding the right of an expert to offer opinions and the value of an expert's experience and qualifications.

Assuming that the particular judge is not friendly toward an entirely new jury instruction spelling out all the reasons that the defendant should be considered liable only in a civil sense rather than convicted criminally, there are subtle alternatives that may be helpful during closing arguments and in the jury room.

Within the jury instruction regarding expert witnesses, for example, defense counsel can argue for a statement that the defendant should not be held to the same standards of knowledge as experts unless the government meets its burden of demonstrating that particular knowledge beyond a reasonable doubt.

In addition, within the same instruction, defense counsel can argue for a statement reminding the jury of differences between civil and criminal cases.

Even the evidence from outside professionals and the most favorable jury instructions may not be enough for defense counsel in the Poulsen case.

Without a helpful jury instruction, however, defense counsel may be left with nothing more than a desperate argument about the beyond a reasonable doubt standard and the American flag.

Given the anticipated evidence, what may essentially be an argument for jury nullification will likely find little natural sympathy, making a helpful jury instruction that much more important.

Future securities fraud cases may provide better opportunities than does Poulsen's case for distinguishing between civil and criminal fraud through the use of outside professionals and related jury instructions.

There is a difference between civil fraud and criminal fraud. Perhaps like Justice Potter describing pornography, jurists who have trouble describing in advance the exact line between civil fraud and criminal fraud might just know it when they see it. Outside professionals and jury instructions might help shift that line in appropriate cases.

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