

Investigations and Criminal Litigation

The Perils of Parallel Proceedings—Is There Light at the End of the Tunnel?

Parallel proceedings (independent investigations conducted by civil regulatory agencies and federal prosecutors relating to the same set of operative facts and circumstances) are a familiar feature in today's regulatory enforcement landscape and pose complex challenges for corporations and the executives who run them. Such proceedings highlight the danger posed to companies and their executives in situations where voluntary cooperation with a civil regulatory enforcement investigation—which, now more than ever in our post-Enron, post-Sarbanes world, is the standard course for a public company facing an investigation by its principal regulator—can lead, perhaps unwittingly, to much greater exposure in the form of a criminal prosecution.

However, in a recent federal court decision that has garnered much attention, *United States v. Stringer*, 408 F.Supp.2d 1083 (D. Or. Jan. 9, 2006), a federal district judge may have begun to level the playing field. In *Stringer*, the court found that by using a civil investigation conducted by the Securities and Exchange Commission (SEC) to cloak a parallel and ongoing criminal investigation, the federal prosecutors had engaged in misconduct warranting the dismissal of the indictment or, alternatively, the suppression of all evidence gathered by the SEC.

The *Stringer* decision does not change the government's well-established ability to conduct parallel civil enforcement and criminal proceedings¹. However, *Stringer*, and an earlier federal court decision dismissing perjury charges against former HealthSouth CEO Richard Scrushy², may augur an era of heightened judicial scrutiny of the manner in which the government conducts parallel civil and criminal investigations and the quality of disclosures made to the targets of such investigations.

United States v. Stringer

In *Stringer*, the three defendants were employed as the chief executive officer (CEO), the chief financial officer (CFO)

and the senior vice president (SVP) at a technology company based in Oregon. In 2000, the company became the subject of an SEC investigation. Shortly thereafter, the defendants were removed from their positions, upon the discovery of misstatements in the company's public SEC filings concerning inflated revenue and profit figures. After cooperating with the investigation, the company settled with the SEC in 2002—agreeing to an administrative cease-and-desist order without receiving any fine. On the same day the settlement was announced, the SEC filed a civil complaint against the CEO, CFO and SVP. Approximately one year later, all three were charged in a 47-count indictment alleging their participation in a conspiracy to engage in securities fraud, and with making false statements to the SEC. The defendants filed pre-trial motions to dismiss the indictment and to suppress the evidence gathered by the SEC, contending, among other grounds, that the SEC and the United States Attorney's Office for the District of Oregon (USAO) had not conducted independent civil and criminal investigations.

The Conduct of the Parallel Investigations in *Stringer*

In support of their motions, the defendants sought and obtained discovery from the SEC, the USAO, the FBI, and the company, relating to the conduct of the respective SEC and USAO investigations. The court ordered the production of a substantial number of government records, including email exchanges between the prosecutors and the SEC staff, records of communication between the SEC and company counsel, notes from meetings between the civil and criminal investigators, and internal memoranda prepared by the prosecutors, FBI agents and SEC staff. Ultimately, 11 days of hearings were conducted.

In dissecting the record of government communications, the court focused on three aspects of the collaboration between the SEC and the USAO: (i) the timing and the extent of that collaboration; (ii) the government's deliberate decision to rely on the SEC investigation to generate

evidence; and (iii) the SEC's active concealment of the existence of the criminal investigation, including the failure to seek disqualification of company counsel from providing joint representation to an individual defendant.

First, with respect to the scope and timing of the collaboration between the SEC and the prosecutors, the court noted that “shortly” after the SEC began its investigation in mid-2000, an Assistant US Attorney met with the SEC staff and was granted access to the SEC investigation files, and that during the next several months, the prosecutors had “extensive discussions of the case” with the SEC and received “five notebooks of documents and a detailed memorandum setting forth the SEC’s legal and factual analysis.” SEC internal emails also reflected that, shortly after a prosecutor had indicated an interest in pursuing perjury charges, the SEC provided information to “all [its] testimony takers [on how] to create the best record possible” in order for the prosecutors to bring a false testimony case. Finally, in order to establish venue for obstruction charges in the District of Oregon, the SEC further agreed to the prosecutors’ request to have witness interviews take place in Oregon³.

Second, the government records revealed the degree to which the prosecutors relied on the SEC to conduct the investigation on its behalf. For example, an internal FBI memorandum noted that federal prosecutors, SEC staff and an FBI agent had met and agreed that “the FBI will make no effort to interview Stringer or other corporate officers at this time *so as not to jeopardize the opportunity to obtain statements from these individuals.*” (Emphasis added.) Presumably, the concern was that the early emergence of the FBI would have caused Stringer and the other corporate defendants to invoke their Fifth Amendment rights against self-incrimination in any SEC interview.

By mid 2001—more than two years prior to the return of the indictment—the prosecutors had identified two corporate officers as “targets,” and had informed the SEC⁴. Yet, according to an SEC attorney’s notes, the USAO agreed “to wait before commencing parallel proceedings,” out of concern that the presence of a criminal proceeding would cause “the SEC action [to] be stayed.” According to the notes of another SEC attorney, the SEC and the prosecutors met again at the end of 2001 and agreed that it was “premature [for prosecutors] to surface” because the awareness of a criminal investigation could undermine the SEC’s ability to gather evidence.

Third, the government records revealed that the prosecutors and the SEC were conscious of the fact that disclosing the existence of a criminal investigation could undermine

the SEC’s ability to obtain testimony from the individual defendants. An email from an SEC attorney to a prosecutor advised the prosecutor not to “surface to company counsel” at SEC interviews until he had discussed the issue with the SEC. The SEC attorney’s notes also reminded her to ask court reporters not to disclose the collaboration between the SEC and a prosecutor. Finally, and most significantly to the court, when counsel for one of the defendants asked the SEC attorney whether the SEC was “working in conjunction with [] the US Attorney’s Office [] or the Department of Justice,” the SEC attorney did not respond directly, but referred the defense counsel to the “routine use” provisions in the SEC Form 1662.⁵

The court also singled out the SEC’s failure to seek disqualification of company counsel from representing individual defendants in the SEC investigation. After becoming aware of the criminal investigation, an SEC attorney wrote to company counsel and urged her to “stringently evaluate and assess [company counsel’s] conflicts.” However, the SEC attorney was satisfied with company counsel’s reassurance of being fully aware of her ethical obligations and did not further pursue the issue. According to the court, because the SEC had knowledge of the existence of a criminal investigation and the likely prospect of criminal prosecution, it had an affirmative obligation to move to disqualify counsel. The court further noted that the failure to seek disqualification had redounded to the CFO’s detriment because the SEC later was able to obtain information from company counsel that had been disclosed to counsel by the CFO.

Key Holdings in *Stringer*

Three key holdings underpin the court’s conclusion that the parallel investigations in *Stringer* violated the defendants’ constitutional rights. The court held that the government had abused the investigative process and violated the defendants’ due process rights because: (i) the prosecutors had effectively opted to gather information through the SEC and to conceal the criminal investigation; (ii) the SEC’s active and conscious efforts to conceal the criminal investigation rose to the level of “deceit, trickery or intentional misrepresentation;” and (iii) once the government became aware of a serious criminal investigation into the conduct of an individual jointly represented by company counsel, the government bore the affirmative obligation to seek disqualification of company counsel, and the failure to do so constituted an interference with an individual defendant’s right to due process.

After concluding that the government had violated each defendant’s right to due process and the right against self-

incrimination, the court further held that the dismissal of indictments against all three defendants was required in addition to the suppression of evidence obtained by the SEC. According to the court, the extent of government overreaching in *Stringer* was “so grossly shocking and so outrageous as to violate the universal sense of justice.”

Implications of *Stringer*

To the extent that *Stringer* augurs increased judicial scrutiny of the conduct of parallel investigations by regulators and prosecutors, it may lead to several changes that would enhance the fairness of the process and help ensure that companies committed to cooperating fully with their regulators are not then unfairly subjected to criminal prosecution as their reward.

There are four factors that may contribute to these changes. First, regulatory agencies may be obligated to provide explicit disclosure regarding the existence of any ongoing criminal investigations. As indicated in both *Stringer* and *Scrushy*, it may be insufficient for regulators to rely on vague language such as the standard instructions provided in SEC Form 1662. For companies and executives under regulatory investigation, it also becomes more important to ask direct questions about criminal exposure, as those questions will require forthright answers.

Second, the more closely regulators and prosecutors collaborate, the more likely their investigations will be examined as a single undertaking and deemed improper or violative of due process rights if disclosure concerning their collaboration is insufficient. Regulators and prosecutors may decide to lessen the extent of their collaboration and minimize the types of interactions that can be construed as one agency receiving direction or instruction from another with no transparency to the companies or executives involved.

Third, because *Stringer* addresses a defendant’s due process rights, its lessons are neither limited to the specific context of SEC/DOJ investigations, nor to federal criminal proceedings alone. In the current regulatory environment, the reverberations of *Stringer* may be felt in other contexts, such as investigations of healthcare fraud, FDA or IRS proceedings, and proceedings before state courts.

Finally, the *Stringer* decision may also influence the conduct of apparently sequential proceedings where civil enforcement agencies, such as the SEC, refer cases to the Department of Justice and state or local prosecutors for criminal investigation or prosecution. Like parallel proceedings, sequential proceedings can often involve interagency coordination that can redound to the detriment of companies and executives because prosecutors typically are entitled to use evidence gathered in the course of a preceding civil investigation. For example, under applicable SEC regulations⁶, the SEC enforcement staff can share evidence obtained in a civil investigation with criminal prosecutors. In the current regulatory environment, sequential proceedings can pose significant challenges to the companies and individuals being investigated, by raising the issues of concern identified in *Stringer*, as civil enforcement agencies often maintain ongoing contact with prosecutors’ offices, thereby heightening the potential for interagency coordination in the investigative stage⁷.

Challenges to sequential civil and criminal proceedings typically rely on the Double Jeopardy Clause and are largely unsuccessful⁸. However, because *Stringer* focuses on the fairness of how the government conducts its investigations, instead of the fairness of sanctions imposed, its logical extension would also permit courts to scrutinize whether civil and criminal investigations are genuinely sequential, or merely structured to appear such to cloak actual coordination. Thus, if a criminal proceeding based on referral from a civil enforcement agency clearly involved interagency coordination at the investigation stage, it may be possible to assert a due process challenge to the prosecution or the evidence.

Notes:

1. See *United States v. Kordel*, 397 U.S. 1 (1970) and *SEC v. Dresser Industries*, 628 F.2d 1368 (D.C. Cir. 1980)
2. *United States v. Scruschy*, 366 F. Supp. 2d 1134 (N.D. Ala. 2005)
3. Coordination between the SEC and the federal prosecutors in arranging the location of a defendant's testimony, and the topics to be addressed, was also a key factor in the decision to dismiss the perjury charge against Richard Scruschy in *United States v. Scruschy*. See *id.*, 366 F. Supp. 2d at 1136, 1139.
4. The Department of Justice's Criminal Resource Manual defines the "target" of an investigation as "a person as to whom the prosecutor or the grand jury has substantial evidence linking him or her to the commission of a crime and who, in the judgment of the prosecutor, is a putative defendant." See *id.*, § 9-11.151. In the context of a federal grand jury investigation, Department of Justice policy requires federal prosecutors to "advise witnesses who are known 'targets' of the investigation that their conduct is being investigated for possible violation of Federal criminal law." *Id.*
5. SEC Form 1662 sets out certain rights of a person giving testimony before the SEC, such as the right to counsel and to invoke the Fifth Amendment privilege against self-incrimination, as well as the "routine uses" provision stating that the SEC "often makes its files available to other governmental agencies, particularly United States Attorneys and state prosecutors" and that "there is a likelihood that information supplied by you will be made available to such agencies where appropriate." *Id.* Form 1662 can be viewed at: <http://www.sec.gov/about/forms/sec1662.pdf>.
6. See 17 C.F.R. §§ 203.2-7.
7. See e.g., *SEC's Mutual Fund Oversight: Hearing Before the House Subcommittee on Commercial and Administrative Law*, (June 7, 2005) (Statement of Lori A. Richards, Director, Office of Compliance Inspections and Examinations, US Securities & Exchange Commission) (available at <http://www.sec.gov/news/testimony/ts060705lar.htm> March 3, 2006).
8. See e.g., *United States v. Polichemi*, 219 F.3d 698, 711 (7th Cir. 2000) (holding that the double jeopardy doctrine does not bar criminal prosecution subsequent to entry of injunctive relief sought by the SEC); *SEC v. Palmisano*, 135 F.3d 860, 866 (2d Cir. 1998).

FOR MORE INFORMATION ON THIS OR OTHER INVESTIGATIONS AND CRIMINAL LITIGATION MATTERS, PLEASE CONTACT:

Boston: Robert D. Keefe robert.keefe@wilmerhale.com

Washington: J. Kevin McCarthy kevin.mccarthy@wilmerhale.com

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