THOMSON REUTERS
Westlaw®

When corporate reporting creates criminal risk: Circuit court limits criminal liability under ambiguous reporting requirements

By James P. McLoughlin Jr., Esq., and Edward P. O'Keefe, Esq., ***Moore & Van Allen PLLC***

MARCH 8, 2021

THIRD CIRCUIT REVERSES CONVICTION OF BANK EXECUTIVES GIVING GUIDANCE ON KEY COMPONENTS OF THE STATUTES CRIMINALIZING FALSE STATEMENTS

Public and regulated corporations face multiple reporting obligations, the contours of which are often unclear, particularly in rapidly evolving economic circumstances. Context plays a significant role in interpreting the key language of a law, regulation or agency guidance.

Past corporate practice, industry behavior, and the complexity of the matter to be reported all provide important touch points. Add the element of timing and rapidly moving macroeconomic or business conditions, and the questions can become significantly judgmental.

> Given the risks inherent to reporting under ambiguous regulations, executives and their legal advisors in any industry should be in active communication to ensure all reasonable interpretations of reporting regulations are evaluated, understood, and chosen with care.

The federal courts continue to develop the standards by which individuals will be held accountable for what the government deems to be reporting failures.

A number of circuit courts have held the "fair warning" doctrine and due process demand that the government prove a defendant's report is false under every objectively reasonable interpretation of the reporting requirement — even if the defendant did not consider interpretation under which the report would be accurate. Otherwise, reporting officers would be at personal risk when they face ambiguous reporting requirements and cannot know with "ascertainable certainty" whether their statement will be considered false.

In effect, if the regulator fails to give fair warning, conviction may not follow. However, this argument may not forestall an indictment; it most often requires a more receptive audience — a federal judge. As in this case, prosecutors are unlikely to be persuaded by arguments based on regulatory ambiguity, naturally defaulting to the view the court can be persuaded the requirement is not ambiguous.

Building on this body of law, on January 12, 2021, the Third Circuit issued its decision in *United States v. Harra*, 985 F.3d 196 (3d Cir. Jan. 12, 2021), defining the role of falsity in cases alleging a violation of 18 U.S.C.A. § 1001, which criminalizes false statements made to the government.

The circuit court held that in order to convict, the government must prove either that its interpretation of a potentially ambiguous reporting requirement is the only objectively reasonable interpretation; or, if the defendant has proposed an alternative objectively reasonable interpretation of the reporting requirement, that the defendant's statement was false under both the government's and the defendant's interpretations — even if that alternative reading is not the interpretation the defendant used when reporting. Further, the issue of whether the alternative is, in fact, objectively reasonable, is for the jury.

IN THE TRIAL COURT

As described by the court, the case arose from the bank's management of term loans for real estate development under which the borrower could make monthly interest payments and repay the principle at maturity. Because the loans typically financed construction projects, the loans could be extended or refinanced.

Consistent with general practice at the time, extensions and refinancings were relatively commonplace, and such loans were not treated or reported as past due. And, the extensions or refinancings were not always fully documented. The SEC, the Federal Reserve, and the Office of Thrift Supervision ("OTS"), which is now part of the Office of the Comptroller of the Currency, all had regulations requiring the reporting of past due loans. The bank's extended term loans were not reported as past due.

Prior to 2009 extended and refinanced construction loans were a relatively small percentage of the bank's portfolio, but in 2009, that volume rose exponentially. As a result, the government charged that in 2009, the bank issued mass extensions of the term loans, without underwriting or individualized documentation, in a "waiver program" to avoid reporting the loans as past due.

Ultimately, in July 2010, the bank changed its practice to treat all matured, unpaid term loans as past due and included the extended loans, then totaling about $296.6 million, on reports to the federal regulators. The change had a material, negative impact on the bank, which was ultimately acquired.

Four senior executives, the former president, CFO, chief credit officer, and controller, were indicted for conspiracy to defraud the United States, to commit securities fraud, and to make false statements to regulators in violation of 18 U.S.C.A. § 371; securities fraud in violation of 18 U.S.C.A. § 1348; multiple counts of making false statements to the SEC and Federal Reserve in violation of 18 U.S.C.A. § 1001 and 15 U.S.C.A. § 78m; and one executive was charged with falsely certifying financial reports in violation of 18 U.S.C.A. § 1350.

Each of the charges depended upon the falsity of the bank's reporting as to "past due loans in its waiver program." In addition, the government alleged that the mass extensions constituted a separate scheme to defraud that was the basis for the conspiracy charge, arguing a theory that the defendants had pretended the loans were not overdue when, in fact, they were.

At trial, the defendants responded that the regulatory guidelines were ambiguous, and under the then-OTS guidance defining a "past due" loan, which could be applied to all the regulators' reporting requirements, the loans extended under the waiver program were not past due. Therefore, the loans did not have to be reported.

The defendants argued the jury must be instructed that in order to convict, it must find the government had proven the reports were false under any objectively reasonable interpretation of the reporting requirement, regardless of what interpretation any particular defendant believed when reporting — and even if the defendant had believed that the report was false under the interpretation that defendant had, in fact, employed.

Thus, even if the defendant had believed that the report was false, if it was not false under a different reasonable interpretation, the jury could not convict. The government argued its burden to prove falsity is merely to prove that defendant understood the reporting requirement as the government interpreted it, and, in light of that meaning, intended to make a false statement.

The trial court ruled that the SEC and Federal Reserve reporting requirements were not ambiguous, but even if they were, the OTS guidance, which arguably excluded from reporting loans given informal extensions without documentation, was not an objectively reasonable interpretation of the term "past due." After the court ruled that the jury could consider that OTS guidance only as it related to the defendants' subjective intent, the defendants were convicted on all counts.

IN THE THIRD CIRCUIT

The defendants' successful challenge was not that they lacked scienter (although they made that argument as well), but that the government had failed to prove that the filings were false under their proposed, objectively reasonable interpretation of ambiguous regulations. The Third Circuit agreed with the defendants, joining several circuits in holding that the prosecution must prove a statement is false under any objectively reasonable interpretation of an ambiguous regulation.

The court anchored its reasoning on the due process requirement that a defendant must be given "fair warning" of conduct that is criminal, so the defendant can avoid violating the law. The court concluded that the defendant must be able to know with "ascertainable certainty" whether a statement will be considered false under any reporting regulation. Also important, the court noted the same fair warning requirement applies in civil cases brought by the government.

The court distinguished between reporting requirements that are "ambiguous" and those that are "fundamentally ambiguous." Defining an ambiguous reporting regulation as one from which a definition can be divined from the context, and a fundamentally ambiguous requirement as one there is no rational basis for making the choice between alternative meanings, the court ruled that a fundamentally ambiguous regulation can be identified as a matter of law and cannot be the basis of a conviction for false statements as a matter of law.

It is up to the trial judge to make a preliminary determination that alternative readings render the reporting requirement potentially ambiguous based on the evidence offered. Once the trial court determines as a preliminary matter an alternative interpretation is objectively reasonable, the final determination is a question for the jury.

The trial court should take into account all of the circumstances, including the particular characteristics of the defendant, what a reasonable person under the circumstances would believe or understand, prevailing professional norms, and the perspective of a reasonable professional in that industry. The inquiry is always an objective one.

The Third Circuit reversed all convictions based on false reporting and remanded for possible retrial on the allegations that the defendants had conspired to use mass extensions as a scheme to hide past due loans in violation of the securities laws.

The first take-away from the experience of these defendants is that given the risks inherent to reporting under ambiguous regulations, executives and their legal advisors in any industry should be in active communication to ensure all reasonable interpretations of reporting regulations are evaluated, understood, and chosen with care. Critical assessment and thinking are essential.

Reporting requirements can be so complex that alternative readings — and the consequent risks for reporting persons — may not be obvious. The same is true for interpretations that reduce risk. All alternatives must be analyzed and understood, which may mean engaging with the regulator.

For reporting persons reluctant to engage with regulators about the meaning of reporting regulations, the risks of that decision should not be underestimated — even if the reporting person's interpretation is ultimately proved to be reasonable. Whether or not the regulator is engaged, reliance on counsel to advise on the interpretations of the regulation can provide a critical defense to criminal or civil regulatory risk.

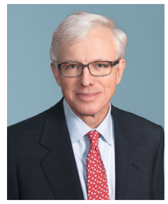
Second, bringing false statement charges is one of DOJ's go-to tactics. For lawyers defending these cases, pre- and post-indictment, the *Harra* case and similar decisions point to important strategies.

The Third Circuit instructs that the interpretation of a potentially ambiguous reporting requirement is part fact, part law and evidence should be heard — opening the door for fact and expert testimony on context, industry practice and a host of other factors.

Another is to argue the government must strictly separate and prove each essential element and prove the scienter requirement for each essential element as independent proof requirements. See, for example, *Rehaif v. United States*, 139 S. Ct. 2191, 2195 (2019).

This article was published on Westlaw Today on March 8, 2021.

ABOUT THE AUTHORS




James "Jim" P. McLoughlin Jr. (L), a member in **Moore & Van Allen PLLC**'s Charlotte, North Carolina, office, has 35 years of experience representing clients in regulatory and criminal investigations and cases conducted by the U.S. Justice Department, the Securities and Exchange Commission, the IRS, the Commodities Futures Trading Commission and state attorneys general. He can be reached at jimmcloughlin@mvalaw.com. **Edward P. O'Keefe** (R), also a member in Moore & Van Allen's Charlotte office, advises and represents financial institutions. His experience includes investigations, litigation, regulatory compliance, governance, cybersecurity, compensation and risk management. He can be reached at edwardokeefe@mvalaw.com.