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The Benefit of a Bargain: When a Lie Is Not a Fraud

By **Richard M. Strassberg**

And **Valerie A. Haggans**

Don't lie. Not a very controversial statement. In fact, it is common advice, given by lawyers and parents to clients and children, alike. It is considered particularly good advice in the white collar world, where lies can lead to fraud charges that can result in all sorts of bad consequences. But not all lies are the same. And not all lies can support federal criminal convictions. Two cases before the U.S. Court of Appeals for the Second Circuit may help define the contours of when lies are not frauds.

On May 13, 2015, the Second Circuit heard argument in *United States v. Litvak*, an appeal arguing that lies supporting a securities fraud conviction were legally insufficient to be the basis for a crime. Jesse Litvak was convicted of lying to his clients about, among other things, the amount he paid to purchase bonds he sold to them. He argued on appeal that his lies were not material and could not support fraud charges because his clients received the securities they agreed to purchase at the prices they agreed to pay. While materiality is always, to some extent, a fact based inquiry, the argument in *Litvak* focused on the alleged lack of materiality of lies made in the negotiation process that are arguably unrelated to the value of the underlying transaction.[1]

While not cited in *Litvak*, the little known "No-Sale Doctrine" provides that some lies, even if material, cannot support federal fraud charges. The "No-Sale Doctrine," articulated by the Second Circuit in *United States v. Shellef*, holds that lies that may be material enough to cause someone to enter into a transaction they otherwise would have avoided, will still not be sufficient to support a federal fraud charge unless the lies expose the victim to possible economic harm.[2] If there is no discrepancy between the benefits reasonably anticipated from the transaction and the benefits actually received from the transaction, *Shellef* makes clear that there can be no federal fraud liability, even where the lie induced the victim to enter into the transaction and would qualify as "material" under most legal definitions of materiality.[3]

While there have been few decisions interpreting the scope of the No-Sale Doctrine since it was announced in *Shellef* in 2007, the Second Circuit is now poised to revisit it in *United States v. Binday*, a case currently pending on its docket.[4]

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The Shellef Rule

In *Shellef*, the defendants were distributors of a highly regulated chemical called CFC-113. As a result of its ozone-depleting properties, the U.S. government sought to discourage the production of CFC-113 by subjecting domestic sales to high excise taxes. CFC-113, however, could be sold to foreign purchasers tax-free. The defendant distributors told their suppliers of CFC-113 that they would only sell it internationally, and so no taxes were applicable. But they actually sold some of it in the United States, contrary to their representations, and without paying the taxes.

The government premised its fraud charge, among other grounds, on a theory that absent the misrepresentations, the suppliers would not have sold the CFC-113 to the distributors, and thus that, absent the lies, there would have been no sale. On appeal, the Second Circuit rejected that theory. The court explained that: "Our cases have drawn a fine line between schemes that do no more than cause their victims to enter into transactions they would otherwise avoid—which do not violate the mail or wire fraud statutes—and schemes that depend for their completion on a misrepresentation of an essential element of the bargain—which do violate the mail and wire fraud statutes."[5]

The court found that the misrepresentation at issue in *Shellef*—the distributors' claims that the CFC-113 would only be sold internationally, and thus excise-tax free—was not an essential element of the bargain, as the government "[d]id not allege…that there was a discrepancy between benefits reasonably anticipated and actual benefits received."[6]

The Shellef decision relied upon a line of Second Circuit cases that considered when a fraudulent statement can be considered an essential element of the bargain, such that it will support a federal fraud charge. For example, in *United States v. Regent Office Supply Co.*, the defendants were stationery sellers who misrepresented their identity to prospective customers in order to get the customers to enter into transactions with them. Among other things, in order to avoid being dismissed as a random "sales pitch," the defendants lied and told prospective customers that they had been referred by friends and colleagues.

The court found the government's allegations insufficient to sustain a fraud case, holding that "where the representations do not mislead as to the quality, adequacy or inherent worth of the goods themselves, fraud in the bargaining may be inferable from facts indicating a discrepancy between benefits reasonably anticipated because

RICHARD M. STRASSBERG *is a partner at Goodwin Procter and chair of its white collar crime and government Investigations practice. He was formerly chief of the Major Crimes Unit in the U.S. Attorney's Office for the Southern District of New York.* VALERIE A. HAGGANS *is a senior associate at Goodwin.*

of the misleading representations and the actual benefits which the defendant delivered."[7]

The Shellef court also relied upon *United States v. Starr*. The defendants in *Starr* were bulk-mailers. They developed a scheme whereby they hid pieces of high-rate mail in sacks full of low-rate mail, and paid the low rate to the Postal Service for the entire sack, but they still charged their customers the higher postage rate, pocketing the difference.

The Second Circuit found no federal fraud scheme had been alleged, as the defendants "did in fact mail their customers' [parcels] promptly as promised and caused them to arrive at the correct destination," and held that "[m]isrepresentations amounting only to a deceit are insufficient to maintain a mail or wire fraud prosecution. Instead, the deceit must be coupled with a contemplated harm to the victim. Moreover, the harm contemplated must affect the very nature of the bargain itself."[8]

District Court Decisions

The Second Circuit has not addressed the scope of the No-Sale Doctrine since its ruling in *Shellef* in 2007. During that time, few district courts have grappled with the doctrine, and those courts confronted with the theory have struggled to apply it uniformly.

Early this year, in *Efans Trading*, the Southern District of New York rejected the defendants' challenge, based on *Shellef*, to a civil forfeiture complaint based on an alleged fraud scheme seeking to exploit the arbitrage opportunity involved in purchasing luxury cars made for sale within the United States and immediately exporting them to other countries, because a high-end exotic vehicle can net double or triple its value overseas. The defendants argued that the complaint did not establish "actual fraud," because it did not properly allege fraudulent intent under *Shellef*. The court found the complaint sufficient "because it has alleged an intent to defraud—rather than a mere intent to deceive," and identified various ways the defendants' actions contemplated harm to the manufacturers, dealerships, and insurance companies involved as victims in the scheme.[9]

Similarly, in *United States v. Walters*, the Eastern District of New York upheld a fraud prosecution over the defendants' Shellef challenge, finding that the defendants' alleged scheme necessarily passed along the economic cost of the fraud to the victim, and therefore contemplated harm to the victim. In *Walters*, the defendants were real estate developers, engaged by the New York City Department of Housing Preservation and Development (HPD) to help select general contractors to manage the construction of affordable housing projects. The defendants solicited and received kickback payments from certain general contractors in exchange for awarding them work, and included the amounts of the kickback payments in requisitions submitted to HPD on behalf of the contractors. The defendants, invoking *Shellef*, argued that any misrepresentation contained in the requisitions submitted to HPD "amounts only to deceit" because the government did not allege that "HPD actually paid more than it would have in the absence of the alleged fraud."

The court rejected that argument, holding: "[t]here can be no doubt that the object of the contract between HPD and the developers was to obtain certain services at a competitively selected price. By padding their requisition forms so that HPD would have to absorb the costs of the kickbacks, Defendants inflated the true cost of the services provided, which amounts to a misrepresentation that goes to the very nature of the bargain."[10]

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In contrast, in *United States v. Lebovitz*, in the Eastern District of New York, the defendants were brokers for stranger-owned life insurance (STOLI) policies. STOLI policies are universal life insurance policies in which the original purchaser of the policy intends to resell the policy to an investor. The defendants submitted applications for life insurance that provided false answers to questions designed to weed out STOLI policies, so that the life insurance companies would issue the policies without identifying them as STOLI.

In his report and recommendation on the defendants' motion to dismiss the indictment, Magistrate Judge Steven Gold held that without allegations of contemplated economic harm, the government's prosecution risks running afoul of *Shellef*: "[I]f the government's proof at trial establishes only that insurance companies would prefer not to issue [STOLI policies], and that the reasons for this preference on the part of the insurance companies *have nothing to do with* the risks and rewards, profits and losses, or other terms of the bargain made when an insurer issues a life insurance policy, defendants may well be in a position to make a compelling motion for a judgment of acquittal."[11]

Late last year, in *Sand International*, a civil asset forfeiture case in the District of Connecticut, the court granted the defendant's motion to dismiss on the grounds that the government's theory of the case was the type of No-Sale prosecution precluded by *Shellef*. *Sand International* also related to a luxury car arbitrage scheme, but, unlike in *Efans Trading*, the court in *Sand International* found that "the government's fraud allegations rest [solely] on the testimony of the BMW dealership indicating that it would not have entered into the contract [to sell a vehicle to the defendant] had it known that the BMW would be immediately sent overseas for resale," which was insufficient to establish fraudulent intent under *Shellef*.[12]

Conclusion

On April 13, 2015, the Second Circuit heard oral argument in *Binday,* a criminal case raising the issue of the scope of the No-Sale Doctrine. The court granted bail pending appeal in that case last fall. The defendants were convicted of mail and wire fraud for brokering STOLI policies. Like the defendants in *Lebowitz*, the Binday defendants were charged with submitting applications for life insurance that provided false answers to questions designed to weed out STOLI policies, so that the STOLI policies would be issued by the insurance companies.

On appeal, the defendants argued that the trial court's jury instruction misstated the law under *Shellef* because it did not require a finding of contemplated economic harm to the life insurance companies.

The recent Litvak and Binday appeals may shed light on what lies will support federal fraud convictions, and how the No-Sale Doctrine will continue to evolve in the Second Circuit.

1. No. 14-2902, Brief of Defendant-Appellant, *22-30 (2d Cir. Nov. 18, 2014).
2. 507 F.3d 82, 108-09 (2d Cir. 2007).
3. A material misstatement is one that "has a natural tendency to influence, or was capable of influencing, the decision of the decisionmaking body to which it was addressed." *Kungys v. United States*, 485 U.S. 759, 770 (1988).
4. No. 14-2809.
5. 507 F.3d at 108.
6. Id. at 109, quoting *United States v. Starr*, 816 F.2d 94, 98 (2d Cir. 1987).
7. 421 F.2d 1174, 1182 (2d Cir. 1970).
8. 816 F.2d 94, 98-99 (2d Cir. 1987). The mail fraud case in *Starr,* for the defrauding of the defendants' customers, was dismissed, but "an indictment for defrauding the Postal Service would have led to a conviction that would surely have been affirmed." 816 F.2d at 102 (Newman, J., concurring).
9. *United States v. Any And All Funds On Deposit In Account Number 0139874788, At Regions Bank, Held In the Name of Efans Trading Corp.*, No. 13-Civ-7983, 2015 WL 247391. *8 (S.D.N.Y. Jan. 20, 2015).
10. 963 F.Supp.2d 125, 131-32 (E.D.N.Y. 2013).
11. No. 11-CR-134 (SJ), 2012 WL 10181099, *7 (E.D.N.Y. Nov. 30, 2012) (emphasis in original).
12. *United States v. $52,037.96 Seized From Account Number XXXXX3161 At JPMorgan Chase & Co. Held In The Name Of Sand International*, No. 3:14-CV-00591-WWE, 2015 WL 7399377, *4 (D. Conn. Dec. 30, 2014).