What "Proceeds"?

This article first appeared in *The New York Law Journal*, October 12, 2009.

by Daniel Margolis and Anne Lefever

Daniel R. Margolis
Litigation
+1.212.858.1758
daniel.margolis@pillsburylaw.com

Daniel Margolis, a partner in the Corporate Investigations & White Collar Defense practice group in the New York office of Pillsbury Winthrop Shaw Pittman, previously served as an Assistant U.S. Attorney in the Asset Forfeiture Unit of the U.S. Attorney's Office for the Southern District of New York, where he represented the government in the 'All Funds' case discussed in this article. Anne Lefever is a litigation associate in the firm's New York office.

On July 31, 2009, the Tenth Circuit reversed a district court's forfeiture order in the high profile insider trading case, *United States v. Nacchio*, No. 07-1311, 2009 WL 2343716 (10th Cir. July 31, 2009). In doing so, the circuit weighed in on a controversy brewing in the Southern District of New York over the correct interpretation of the term "proceeds" as used in the Civil Asset Forfeiture Reform Act (CAFRA), codified at 18 U.S.C. §981 et seq. Courts also have recently been divided in interpreting the term in the money laundering context. The result: Congress has amended the money laundering statute to overturn a 2008 Supreme Court decision.[1]

The primary issue in each of these cases was whether the term "proceeds" refers to gross profits or net profits of a defendant's crime. These recent judicial and legislative developments present interesting issues of statutory interpretation that have significant ramifications for the many defendants currently being charged with white-collar crimes.

In the Context of Forfeiture

In the forfeiture context, CAFRA utilizes different definitions of "proceeds" depending on the nature of the underlying offense. Section 981(a)(1)(C) of Title 18 subjects to forfeiture the proceeds of hundreds of different felonies, as well as "any offense constituting 'specified unlawful activity'" under §1956(c)(7) of Title 18 (the money laundering statute).

For offenses involving "illegal goods, illegal services, unlawful activities, and telemarketing and health care fraud schemes," "proceeds" is defined in subsection (A) of §981(a)(2) as gross receipts.[2] For offenses involving "lawful goods or lawful services that are sold or provided in an illegal manner," "proceeds" is defined in subsection (B) as "the amount of money acquired through the illegal transactions resulting in the forfeiture, less the direct costs incurred in providing the goods or services," generally referred to as net profit.[3] Despite the express definitions of "proceeds," the statute leaves undefined the terms "illegal goods," "illegal services," "unlawful activities," "lawful goods" and "lawful services."

Those involved in the drafting of CAFRA have said that the bifurcated definition of "proceeds" represented a compromise between those advocating a punitive purpose for forfeiture ("gross receipts") and those advocating a remedial one ("net profits").[4] The statutory

language resulting from this compromise, however, provided little explanation on how a particular offense should be categorized. Not surprisingly, courts have differed in their interpretations of the statute.

In *United States v. All Funds on Deposit in United Bank of Switzerland*, 188 F. Supp. 2d 407 (S.D.N.Y. 2002) ("All Funds"), claimant allegedly had transferred millions of dollars from the United States to Iran in violation of the Iran sanctions program.[5] The funds seized from a New York account consisted of customer deposits intended for transfer to Iran as well as fees paid by claimant's customers for its transfer services.

In moving to dismiss the forfeiture complaint, claimant argued that because currency exchange is an inherently lawful service, the definition of "proceeds" in subsection (B) of §981(a)(2) applied. According to claimant, the only profit that it derived from the transfers was the customer fees; the funds in the account were merely the customers' deposits that flowed to Iran and so these sums were not profits. Under subsection (B), only claimant's profit was forfeitable and, therefore, the government was entitled only to the small percentage of funds in the account representing the customers' fees. The government argued that transferring money to Iran was an "illegal service," and therefore subsection (A) applied.

Judge Jed Rakoff, of the U.S. District Court for the Southern District of New York, decided that the gross proceeds should be subject to forfeiture, but based on neither of the parties' arguments. He observed that §981(a)(1)(C) subjected to forfeiture any proceeds of an offense constituting a "specified unlawful activity" under 18 U.S.C. §1956(c)(7).

Because violation of the Iran sanctions program was a "specified unlawful activity" under §1956(c)(7), it necessarily constituted an "unlawful activity" under §981(a)(2)(A), thereby subjecting the alleged wrongdoer's gross receipts to forfeiture. Two additional factors shaped the court's conclusion: (1) the absence of any reference to "unlawful activities" in subsection (B), and (2) that Congress' purpose in enacting subsection (B) was to "subject those involved in violations at which the money-laundering statute was not directed to a more narrowly defined scope of forfeiture."[6]

Earlier this year, U.S. District Judge Robert Patterson, also of the Southern District of New York, confronted the same provision in §981 and reached the opposite conclusion. The defendant in *United States v. Kalish*, No. 06 Cr. 656(RPP), 2009 WL 130215 (S.D.N.Y. Jan. 13, 2009), was convicted of mail and wire fraud in connection with an advanced fee scheme. The defendant requested that the court modify the $8.4 million forfeiture judgment against him in part on the ground that under §981(a)(2)(B) he should be permitted to deduct the sales commissions paid to his independent contractor salesmen as compensation for operating the scheme.

The defendant argued that the term "proceeds" was ambiguous and, analogizing to the money laundering context, that U.S. Supreme Court precedent mandated application of the more narrow definition of net profits in subsection (B). The government relied on All Funds to argue that because mail and wire fraud were "specified unlawful activities" under U.S.C. §1956, the offenses were "unlawful activities" under §981 and thus the defendant's gross proceeds were subject to forfeiture under subsection (A).

Judge Patterson did not find the government's argument compelling. Had Congress intended "unlawful activity" in subsection (A) to be coextensive with "specified unlawful activity" in the money laundering statute, the court opined, "it would have used that precise term—as it did in Section 981(a)(1)(C)—instead of the looser term 'unlawful activities.'"[7] Construing subsection (A) in this manner rendered subsection (B) essentially purposeless, and thus the government's argument was inconsistent with the principle of statutory interpretation requiring that two statutory provisions be read together to discern the meaning of either of them.

Concluding that mail and wire fraud were not automatically "unlawful activities" under subsection (A) just because they were "specified unlawful activities" under the money laundering statute, the court next considered whether the statute provided any guidance as to whether these offenses were "unlawful activities" based on a rationale other than that advanced by the government, or whether they constituted "lawful services provided in an illegal manner." Citing Supreme Court precedent from the money laundering context, Judge Patterson concluded that the term "proceeds"

was ambiguous.[8] The rule of lenity mandated application of the narrow definition of proceeds as "net profits" under subsection (B) and thus the sales commissions were deductible.

Though the Second Circuit has yet to opine on the issue over which Judge Rakoff and Judge Patterson have disagreed, the Tenth Circuit was directly presented with the issue in *Nacchio*.[9] There, a three-judge panel reversed a district court order requiring forfeiture of approximately $52 million in gross receipts and, after addressing the *All Funds* and *Kalish* opinions, the panel held that only the defendant's net profits were subject to the order.

After a high-profile jury trial resulting in the defendant's conviction on 24 counts of insider trading, a federal district court in Colorado had granted the government's motion for entry of a money judgment based on the gross proceeds of the impugned sales.[10] Mr. Nacchio had argued unsuccessfully before the district court that: (1) securities trading was a lawful service which he had, by using inside information, performed in an illegal manner; (2) subsection (B) of §981(a)(2) applied, and; (3) the monies constituting his broker commissions and taxes were overhead costs that were not subject to forfeiture.

The district court rejected Mr. Nacchio's argument based on the "elementary observation" that "a security is not a good, it is a commodity" and therefore subsection (B), which only applied to goods and services, was inapplicable. Following *All Funds*, the district court went on to note that securities fraud is a "specific (sic) unlawful activity" under §1956 and therefore subsection (A) applied.

On appeal, Mr. Nacchio advanced the same argument he made before the district court. Without making any attempt to reconcile the two S.D.N.Y. decisions, the Tenth Circuit expressly disagreed with the reasoning in *All Funds* supporting the conclusion that all "specified unlawful activities" automatically fall within the scope of subsection (A). Echoing Judge Patterson's ruling in *Kalish*, the court reasoned that Congress would have used the precise term "specified unlawful activities" instead of "unlawful activities" in §981(a)(2)(A) "if it had meant for the two provisions to be coterminous in terms of covered offenses."[11] The court went on to determine that securities were lawful as opposed to unlawful, and, after rejecting the district court's conclusion that securities were commodities and not goods, applied the "net profits" definition of proceeds in subsection (B).

The Money Laundering Context

Just one year before *Kalish* and *Nacchio* addressed the issue in the forfeiture context, the U.S. Supreme Court addressed the definition of "proceeds" in the money laundering context in *United States v. Santos*, 128 S. Ct. 2020 (2008). Unlike CAFRA, which offered two alternative definitions of the term, at the time *Santos* was decided, the money laundering statute left "proceeds" undefined, and simply held culpable anyone who, knowing that the property involved in a financial transaction represents the proceeds of some form of unlawful activity, conducts or attempts to conduct such financial transaction which in fact involves the proceeds of specified unlawful activity...with the intent to promote the carrying on of specified unlawful activity.[12]

The defendants in Santos were convicted of running an illegal gambling operation. The government appealed to the Supreme Court the Seventh Circuit's decision to vacate the defendants' money laundering conviction, which was based on their payment of wages and payouts to employees and winners, respectively. The defendants contended that these transactions did not violate §1956 because "proceeds" in that section referred to net profits, not gross receipts. The government argued that "proceeds" referred to gross receipts and that the transactions violated the statute because otherwise, the statute targeted only criminals who happened to engage in profitable crime.

A plurality of the Court reasoned that because the term "proceeds" was ambiguous, the rule of lenity required it to interpret the undefined term "proceeds" as limited to net profits. Because no evidence established that the employees' wages involved the profits of the illegal gambling operation, the Court affirmed the decision to vacate the money laundering conviction.[13]

Santos did not remain good law for very long. On May 21, 2009, approximately 11 months after the decision, President Obama signed into law the Fraud Enforcement and Recovery Act of 2009 (FERA),

a comprehensive statute that eliminated perceived shortcomings in federal anti-fraud statutes and allocated more than $500 million to investigating and prosecuting fraud.

FERA amended §1956 by explicitly defining the term "proceeds" as "any property derived from or obtained or retained, directly or indirectly, through some form of unlawful activity, including the gross receipts of such activity," thus adopting the definition proposed by the government in *Santos*. Co-sponsor of the bill Senator Patrick Leahy (D-Vt.), who also was involved in drafting CAFRA, heralded the law's potential to "strengthen one of the core offenses in so many fraud cases—money laundering—which was significantly weakened" by *Santos*.[14] According to Senator Leahy, the *Santos* decision was inconsistent with Congressional intent and if left uncorrected, would have allowed fraudsters to escape liability by pleading that their Ponzi scheme or illegal trades had not turned a profit.[15]

Conclusion

With the various statutory definitions of "proceeds" and judicial interpretations of those definitions floating around, it is not surprising that the state of the law in this area can lead to some conflicting results.

Given the passage of FERA, application of the "gross profits" definition in the money laundering context is a *fait accompli*. In the forfeiture context, however, under the Tenth Circuit's holding in *Naccio*, two defendants alleged to have participated in similar fraudulent activity could be subject to two different forfeiture orders depending on whether their fraudulent schemes were profitable or unprofitable, even if the losses to the victims of each scheme were the same.

One logical reading of §981(a)(2) is to limit "illegal services" to crimes such as murder and arson, which services can never be performed in a legal manner. By doing so, the "net profits" definition of subsection (B) would apply to a wide variety of white-collar crimes, including insider trading, investment fraud and securities fraud, all of which involve services that can be performed in a legal or illegal manner.

Even this interpretation of "proceeds" in the forfeiture statute, however, can lead to an incongruous result when it is juxtaposed against Congress' recent amendment to the money laundering statute. Under FERA, in the money laundering context, the "gross receipts" definition would apply to "proceeds" of those same white-collar crimes described above. Thus, at least in the Tenth Circuit, if a defendant obtains a $100,000 investment as part of a Ponzi scheme, but paid investment managers unaware of the scheme $100,000 in salary, the $100,000 would be considered "proceeds" of crime for purposes of the money laundering statute but would not be considered "proceeds" for purposes of the forfeiture statute.

While Congress recently has spoken in the money laundering context, ambiguity still reigns in interpreting "proceeds" in the forfeiture statute, and courts appear willing to rely on the rule of lenity to support application of the "net profits" definition in white-collar matters. As more courts do so, however, Congress will likely take notice and realize that the lawful/unlawful services dichotomy in §981(a)(2) requires further clarification.

Endnotes

1. 1. Fraud Enforcement and Recovery Act, S. 386, 111th Cong. §2 (2009).
2. 2. See 18 U.S.C. §981(a)(2)(A).
3. 3. See 18 U.S.C. §981(a)(2)(B).
4. 4. 1 David B. Smith et al. "Prosecution and Defense of Forfeiture Cases §5-03[1] (Matthew Bender, 2007).
5. 5. Mr. Margolis represented the government in *All Funds* when he was an Assistant U.S. Attorney.
6. 6. *All Funds*, 188 F. Supp. 2d at 410.
7. 7. *Kalish*, 2009 WL 130215, at *7.
8. 8. Id. at *8.
9. 9. Interestingly, the only other federal district court to consider the inconsistency between *Kalish* and *All Funds* was also in the Tenth Circuit. In a decision issued two weeks before the Circuit's reversal in *Nacchio*, a district court in Kansas relied on *All Funds* to apply the "gross receipts" definition of proceeds under subsection (A) in a case involving a mail fraud and identity theft conspiracy. See *United States v. Yass*, No. 08-40008-JAR, 2009 WL 2043494 (D. Kan. July 14, 2009). The court noted in a footnote, without discussion, the contrary ruling in *Kalish*.
10. 10. See *United States v. Nacchio*, 2007 WL 2221437 (D. Col. July 27, 2007).
11. 11. *Nacchio*, 2009 WL 2343716, at *21.
12. 12. 18 U.S.C. 1956(a)(1).
13. 13. *Santos*, 128 S. Ct. at 2031.
14. 14. Feb. 5, 2009, Statement of Sen. Patrick Leahy, Chairman, S. Judiciary Comm. Introducing the Fraud Enforcement and Recovery Act, S. 386, 111th Cong. §2 (2009), available at http://leahy.senate.gov/press/200902/020509b.html.
15. 15. Id.