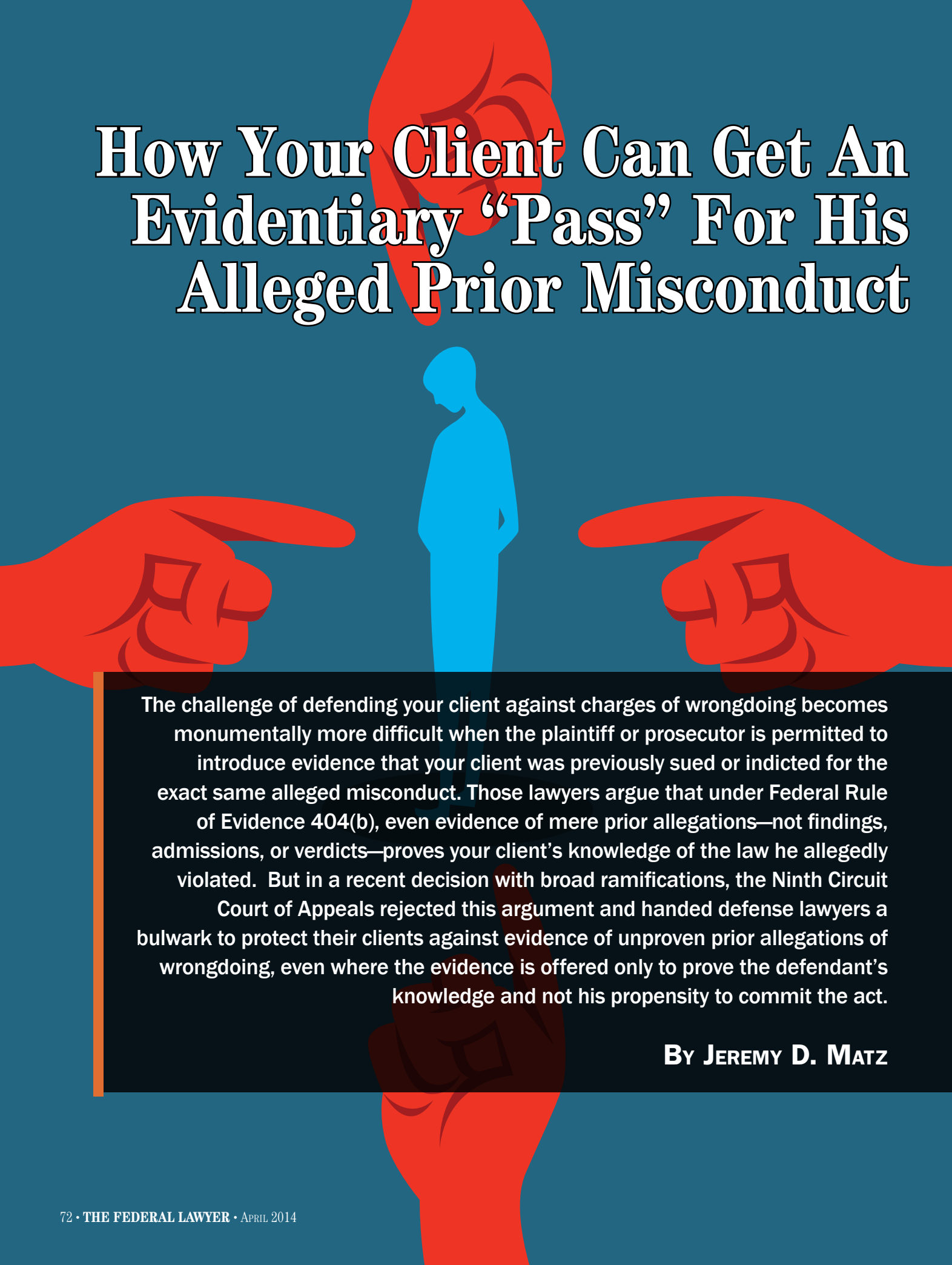
How Your Client Can Get An Evidentiary "Pass" For His Alleged Prior Misconduct



The challenge of defending your client against charges of wrongdoing becomes monumentally more difficult when the plaintiff or prosecutor is permitted to introduce evidence that your client was previously sued or indicted for the exact same alleged misconduct. Those lawyers argue that under Federal Rule of Evidence 404(b), even evidence of mere prior allegations—not findings, admissions, or verdicts—proves your client's knowledge of the law he allegedly violated. But in a recent decision with broad ramifications, the Ninth Circuit Court of Appeals rejected this argument and handed defense lawyers a bulwark to protect their clients against evidence of unproven prior allegations of wrongdoing, even where the evidence is offered only to prove the defendant's knowledge and not his propensity to commit the act.

By Jeremy D. Matz

Suppose you represent a movie studio that owns the copyright in an old film. You learn that a film aficionado, claiming that the movie is in the public domain, has uploaded it to his website and—via social media and e-mail blasts—is encouraging people to watch it. You send him a letter with proof of your client's copyright. Your letter also quotes from the federal Copyright Act and describes how the aficionado is violating it. Defiantly, the aficionado burns the film onto DVDs and starts selling copies over the Internet. You sue in federal court on behalf of your client, seeking enhanced statutory damages based on willful infringement. As you prepare for trial, you would probably assume that the admission into evidence of the cease-and-desist letter (with proof that you sent it), to prove that the defendant knew full well that his DVD selling illegally infringes upon your client's copyright, is a foregone conclusion.

Now suppose you represent a criminal defendant charged with willfully making a false statement on his tax return. The Department of Justice alleges that in the 2010 tax year, your client illegally sheltered hundreds of thousands of dollars of income in bank accounts in Brazil. Your client wants a trial. He earned the disputed income entirely in Brazil from a Brazilian company in which he held only an indirect interest and that did business only in that country. He tells you that he honestly did not believe he had to report the money on his U.S. tax return. But the government has some heavy evidence against your client: in the 2007 tax year, under nearly identical circumstances, he had earned—but had not reported—substantial income, on that occasion from an Argentinian company. After an audit of your client's 2007 tax return, the IRS had issued him a Revenue Agent's Report, informing him that the income was federally taxable, notwithstanding his contention that it was earned and kept overseas. Without admitting liability, your client had settled the audit and paid back taxes, penalties, and interest. The federal prosecutor notifies you that she will offer the 2007 IRS document to prove your client's knowledge that the 2010 Brazilian income was taxable in the United States. Is the prosecutor right that the Revenue Agent's Report is admissible for that purpose?

Not necessarily, based on the rationale of a 2-1 Ninth Circuit decision in August 2012 that could well have far-reaching evidentiary implications favoring individual and corporate defendants in civil and criminal federal cases. Nor, under that decision, is it at all clear that the movie studio's cease-and-desist letter is admissible in the copyright case. Under the Federal Rules of Evidence, the Ninth Circuit held, an earlier Securities and Exchange Commission (SEC) complaint charging a defendant with a civil violation of a securities regulation could not be admitted in a later criminal case against the same defendant for violating the exact same securities regulation on a subsequent occasion, even to prove that the defendant knew about the regulation.

The *Bailey* Decision

The case is *United States v. Bailey.*[1] Before a public company can issue or sell stock, the company must register it with the SEC. To register the stock, the company generally must make voluminous and detailed disclosures about its past performance, key personnel, future business plans, how it intends to use the proceeds from the stock offering, and many other matters. However, SEC Rule S-8 provides an exception for stock issued to the company's employees, consultants, or advisers.[2] If such individuals provide bona fide services to the company, the company may compensate them in stock without making the full disclosures. Once Rule S-8 stock is issued, it is fully and freely tradable on the open market. But stock issued in violation of the rule is deemed not to be registered, meaning that it cannot be legally sold.

Bailey was the president and CEO of a publicly traded health supplements company called Gateway Distributors. He was criminally charged under 15 U.S.C. §§ 77e and 77x with illegally selling unregistered securities, namely, Gateway stock issued in violation of Rule S-8. The government alleged that Bailey illegally issued several hundred thousand dollars of Rule S-8 Gateway stock to a man named Owens, not for any bona fide consulting services, but instead to enable Owens to sell the stock for Gateway's and Bailey's benefit. The indictment charged that Bailey used part of the proceeds to buy a hunting lodge in Utah. Bailey defended on the ground that Owens did in fact render legitimate consulting services to Gateway, making it perfectly legal for Bailey to issue Rule S-8 stock to Owens.

The problem for Bailey was that two years before he issued the stock to Owens, he had issued billions of shares of Rule S-8 stock in Gateway to a different individual and had been sued by the SEC for that alleged Rule S-8 violation. The SEC complaint quoted the rule's requirements, including that Rule S-8 stock could be issued only to employees and consultants for bona fide services rendered and that it could not be issued to raise capital for the company. Bailey had settled the lawsuit without admitting any liability.

In Bailey's criminal trial, the government moved *in limine* to admit the SEC complaint under Federal Rule of Evidence 404(b), which provides that "[e]vidence of a crime, wrong, or other act[, although] not admissible to prove a person's character in order to show that on a particular occasion the person acted in accordance with the character … may be admissible for another purpose, such as proving motive, opportunity, intent, preparation, plan, knowledge, identity, absence of mistake, or lack of accident." The government noted that the criminal securities offense required proof that Bailey had acted "willfully," which the Ninth Circuit has defined in securities cases to mean "intentionally undertaking an act that one knows to be wrongful," although not necessarily an act that one specifically knows to be unlawful or illegal in the sense of a violation of a law on the books.[3] The government argued that the SEC's filing and service of the lawsuit on Bailey was an "other act," admissible under Rule 404(b) to prove Bailey's knowledge of the securities rule and the wrongfulness of his conduct, as well as his intent and lack of mistake.

Bailey fought the motion. He announced that he would not defend the criminal case on the ground that his conduct was unknowing, mistaken, accidental, or not willful. Indeed, he acknowledged that, by the time of the disputed transactions with Owens, he knew full well that Rule S-8 stock may only be issued in exchange for bona fide services. He noted that the government would be introducing his under-oath admission to the SEC that he knew about Rule S-8 and that he would confirm this knowledge in his opening statement. Rather than defend on the ground of ignorance or an innocent mistake, Bailey intended to show that Owens actually did provide services to justify his receipt of the stock. In light of his defense, Bailey argued that what the government really wanted was for the jury to draw the kind of impermissible character/propensity inference that Rule 404(b) forbids: that because Bailey had "done it before" as alleged in the SEC complaint, he must have "done it again" as charged in the criminal indictment.

Citing the general rule that the party with the burden of proof may prove its case with the evidence of its choice, notwithstanding the opponent's offer to admit certain facts,[4] the government replied that the SEC complaint was still admissible in its case in chief. The district court noted that Bailey had not formally stipulated in the criminal case that he knew of Rule S-8 and its requirements at the time he issued the stock to Owens and that in the absence of any such stipulation, the government could "introduce just the fact of the SEC complaint … for the purpose of showing that [Bailey] certainly knew of what he was doing, that it was illegal." Bailey was convicted of two counts of illegally issuing unregistered stock to Owens. He was sentenced to 30 months in federal prison.

In an opinion written by Judge Betty B. Fletcher and joined by Judge Andrew J. Kleinfeld, the Ninth Circuit vacated Bailey's conviction, holding that the government had offered the SEC complaint to prove Bailey's intent to violate Rule S-8, and that admitting it for that purpose was nonharmless error. The court focused on the third prong of the Ninth Circuit's four-prong test that determines whether an "other act" is admissible under Rule 404(b): whether the evidence is sufficient to support a finding that the defendant committed the other act. In light of its theory that the SEC complaint should be admitted simply to prove that Bailey knew what Rule S-8 required and that he intended to violate the rule in the stock sale to Owens, the prosecution contended that the "other act" at issue was not any act that Bailey himself had committed (including his alleged violation of Rule S-8, as described in the SEC lawsuit), but rather an act that the SEC had committed: the act of suing Bailey and serving him with the complaint. But the Ninth Circuit rejected this position, holding that there had to be sufficient evidence to support a jury finding that Bailey actually had violated Rule S-8 earlier. The court held that there was no such evidence: the SEC lawsuit was merely an accusation, which Bailey had settled with no admission of liability.[5]

The *Bailey* Dissent

In a vigorous dissent, Judge Milan D. Smith agreed with the government's position that the "other act" at issue was the service of the SEC complaint itself, not Bailey's commission of the violation alleged in it. In his view, the SEC complaint "apprised Bailey of the pertinent prohibitions and requirements of Rule S-8," and thus was properly admitted to prove Bailey's knowledge of the rule, regardless of his intent to violate it. Whether Bailey actually did the things the SEC alleged he had done was entirely beside the point.[6] Judge Smith's approach was analogous to the admission of an out-of-court statement to prove its effect on the listener (especially the listener's knowledge of a key fact after hearing the statement), rather than to prove its truth. Notwithstanding a hearsay objection, courts routinely uphold the admission of documents for that nontruth purpose.[7]

Knowledge Versus Intent

The *Bailey* majority held that the government had used the SEC complaint to prove Bailey's intent to violate Rule S-8, and rejected the argument that the complaint had been admitted only to prove his knowledge of the rule. But in the key passage likely to have the greatest impact in future cases, the majority went even further than that:

> It must be said, though, that [the SEC] complaint would not establish [Bailey's] knowledge even if the prosecution had purported to use it only for that reason. All a complaint establishes is knowledge of what a plaintiff claims. It does not establish the truth of either the facts asserted in the complaint, or of the law asserted in the complaint. Since the previous complaint was never proved, nor was the truth of any of it conceded, it could not have established knowledge of the law. A complaint may state that cars driving southbound are required to stop at the intersection of 1st and Main, and that the defendant did not stop. But such a complaint establishes neither that southbound vehicles have a duty to stop, nor that the defendant failed to stop. Likewise, the SEC complaint establishes neither [Bailey's] knowledge of the law nor a past wrongful act.[8]

In future cases, prosecutors and civil plaintiffs seeking to introduce a document such as a complaint or a cease-and-desist letter could attempt to skirt this passage by offering the document solely to prove a defendant's knowledge, as opposed to his intent. This theory of admissibility would depend on the quoted "knowledge" passage from *Bailey* being *dicta*.

Although lawyers and judges often use the terms "knowledge" and "intent" interchangeably, in fact they mean different things, and "it is better to draw a distinction between intent (or purpose) on the one hand and knowledge on the other."[9] Indeed, Judge Smith in dissent criticized the *Bailey* majority for "incorrectly conflat[ing] the concepts of intent and knowledge to argue that the [SEC] Complaint was used essentially as propensity evidence" in violation of Rule 404.[10] In an unrelated case also titled *United States v. Bailey,* the Supreme Court noted that a person acts with knowledge if he is aware that a

given result is practically certain to follow from his conduct (whether he desires it or not), whereas he acts with intent or purpose if he consciously desires that result (whatever the likelihood that his conduct will actually cause it).[11] In this sense, intent can be viewed as a higher and more difficult to prove mental state than knowledge.

On the issue of *knowledge,* an earlier allegation that a defendant did something and that a particular consequence ensued—if the defendant was aware of that allegation—could well support an inference that when he later did the same thing again he knew what would come of it, whether he ever committed the earlier act or not. Imagine that my south-side neighbor's lawsuit accuses me of failing to clean out my backyard sump pump, causing the drainage system to back up and flood my neighbor's house. If a year later, my clogged drainage system causes flooding on the other side of my house, my north-side neighbor could introduce the earlier lawsuit to prove that I *knew* what could happen if I neglected to clean out the pump, even if in fact I maintained it properly the year before. By analogy in *Bailey,* the earlier SEC allegation that Bailey had violated Rule S-8 by issuing Gateway stock could support an inference that when he later issued Gateway stock to Owens, he knew what Rule S-8 proscribed. Judge Smith's view in dissent was that because the SEC complaint had been served on Bailey, this inference could be justified even if Bailey never had issued stock illegally in the past as the SEC had charged.[12]

On the issue of *intent*, if a defendant actually committed a past act (as opposed to merely being accused of committing it) and saw a particular result flow from it, there is a strong inference that he hoped for the same result when he did it again. By analogy in *Bailey,* if Bailey in fact had violated Rule S-8 by issuing Gateway stock on the earlier occasion, resulting in easy but illegal money to the company and to himself, one could easily infer that he consciously desired the same outcome when he issued Gateway stock to Owens. But where, as in *Bailey,* a defendant is only accused of a past act—meaning that neither the act nor its result was ever proven or admitted by him—then any inference that he intended its result when he allegedly committed the same act later is far weaker. If all that happened last year was that my south-side neighbor sued me—in other words, if there was no proof that my conduct actually caused his property to flood—that mere allegation would not tend to prove that I *wanted* my north-side neighbor's property to flood this year, especially if I conceded knowledge that insufficient maintenance could collaterally damage my neighbors' properties. Only my actual disregard for my drainage system and the ensuing damage to my south-side neighbor's property could demonstrate that I purposely flooded my north-side neighbor's home.

Thus, the proponents of evidence such as a complaint or a cease-and-desist letter to prove knowledge would argue that the "knowledge" passage in *Bailey* is mere *dicta*, in light of the majority's holding that the government used the SEC complaint to show that Bailey intended to violate Rule S-8 when he issued stock to Owens. The proponents' argument would be that because the *Bailey* majority found the prosecution wrongly used an unproven past SEC allegation as a basis to argue Bailey's later *intent* to break Rule S-8—an inference that, when based on a mere accusation, is weak at best—the majority's sweeping language about the uselessness of the SEC complaint to prove his *knowledge* of the rule's provisions was unnecessary to the holding. A document that constitutes nothing more than an allegation might be incapable of establishing the higher mental state of intent, the proponents would contend, but it certainly can establish the lower mental state of knowledge.

But for three reasons, the key passage in *Bailey* is anything but *dicta*. First, the majority squarely addressed the government's and Judge Smith's contention, acknowledging that "there is some logic to the argument that [the SEC complaint] shows that [Bailey] was on notice of the type of prohibited conduct," but nonetheless holding that "this is not enough. The prosecution was still required to prove that the evidence was sufficient to support a finding that Bailey committed the act charged in the complaint. This a mere complaint cannot do."[13] Second, if the SEC complaint were sufficient to establish Bailey's knowledge of the rule, then his conviction should have been affirmed. On evidentiary issues, the Ninth Circuit generally affirms on any basis supported by the record, even if the district court's decision was based on a different or even unfounded ground.[14] Under this long-established principle, even the erroneous admission of the SEC complaint to demonstrate Bailey's intent would not have been reversible if the complaint could also demonstrate his knowledge. Third, in a petition for panel rehearing, the government—even while not challenging the holding—specifically asked the Ninth Circuit to eliminate the "knowledge" passage, or at least modify it in a footnote. In November 2012, the panel unanimously denied the government's petition.

Looking Ahead: The Future Influence of *Bailey*

At least in the Ninth Circuit, there may well be significant ramifications, far beyond criminal securities fraud cases, from *Bailey's* holding that a defendant's previous receipt of a complaint alleging a law violation has no bearing on his knowledge of the law that he allegedly broke. After all, in *Bailey* the complaint was a formal lawsuit brought by the very federal regulatory agency responsible for enforcing the law allegedly violated, and it was served on the defendant. Even then, the court held, the complaint did not establish that the law was what the agency said it was, or that the defendant knew what the law was.

By analogy in the film piracy case, the cease-and-desist letter would not tend to prove the defendant's knowledge that the Copyright Act prohibited his mass DVD sales. The act authorizes enhanced statutory damages for willful copyright infringement.[15] To prove willfulness, a plaintiff must show that the defendant was actually aware of the infringing activity—i.e., that he knew he was infringing—or that the defendant's actions were the result of reckless disregard for, or willful blindness to, the copyright holder's rights.[16] The movie studio's cease-and-desist letter alleged that the studio held the copyright to the film, described in detail how the defendant was infringing it, and even quoted the Copyright Act verbatim. But the SEC complaint in *Bailey* did the exact same things with regard to Rule S-8 and Bailey's violation of it. The cease-and-desist letter would not tend to establish the infringer's knowledge of the Copyright Act any more than the SEC complaint demonstrated Bailey's knowledge of the SEC regulation.

In the criminal tax case, the government would have to prove that the defendant willfully underreported his income, which in the tax context means a voluntary, intentional violation of a known legal duty.[17] In other words, the government would have to prove that the defendant knew he had a legal duty to report the income he made in Brazil in 2010. In the 2007 Revenue Agent's Report, the IRS had told the defendant in no uncertain terms that he had a legal duty to report the income he made that year in Argentina. But even if the relevant facts of the Argentinian and of the Brazilian income were exactly the same, the IRS' earlier notice to the defendant would not prove that the law required him to report foreign income, or that the defendant was aware of that legal duty, any more than the SEC complaint in *Bailey* proved a legal obligation or the defendant's knowledge of it.

Just like a complaint, these kinds of letters and notices typically contain a mixture of factual claims ("we own this movie but you sold copies," "you sheltered your income") and legal claims ("the law says you can't do what you did"). Some crimes and causes of action require proof that the defendant knew what the governing law provided. But *Bailey* says that even a government complaint that sets forth the governing law and that is served on the defendant does not constitute such proof: a complaint "does not establish the truth of either the facts [or of the law] asserted in [it]."

In the approximately 18 months since the Ninth Circuit decided *Bailey,* no court has yet relied on its reasoning to exclude evidence or to reverse a verdict based on the erroneous admission of evidence similar to the SEC complaint.[18] However, litigants and practitioners are increasingly aware of the decision's potential impact. In a federal criminal case in Nevada, Tarl Brandon was convicted of mortgage fraud and sentenced to 14 years in prison. Brandon's appellate brief, filed in the Ninth Circuit in November 2013, describes how his ex-girlfriend testified that he had "been through a federal investigation before for mortgage fraud" and for that reason wanted to keep his name off of documents. Over his objection and request for a mistrial, the ex-girlfriend's testimony was admitted pursuant to Rule 404(b). On appeal, Brandon cites *Bailey* extensively, arguing that admitting the testimony was reversible error because "the proof of any prior bad act … was even more attenuated than in *Bailey*. It was not even clear that there was any prior investigation at all, much less that Brandon had actually done anything wrong …. Moreover, just as in *Bailey,* even assuming there had been a prior investigation, that is insufficient to support a finding that Brandon committed the prior act at issue, as is required to be admissible under Rule 404(b). As in the case of the filing of a complaint, the mere instituting of an investigation does not provide any evidence that the defendant actually committed any crime."[19]

Thus, in the Ninth Circuit after *Bailey,* parties and attorneys will likely find it more difficult than ever to introduce complaints, letters, notices, and similar documents to prove the opposing party's knowledge.

Epilogue

There is an interesting denouement to *Bailey.* After his convictions were vacated, the government elected to retry him in June 2013. The second time, of course, the government was barred from introducing the SEC complaint. However, before the retrial, Bailey entered into a detailed "Stipulation Regarding SEC Form S-8." The stipulation described how Rule S-8 operates and what it permits and prohibits. It also stated: "At all times relevant to the charges in this case, Bailey knew and understood the rules pertaining to SEC Form S-8." The stipulation thus conclusively established Bailey's knowledge, but it still left the government having to prove his willfulness, which in turn required proof of his intent to violate Rule S-8.[20] According to the Ninth Circuit majority that vacated his first conviction, that should have been quite a difficult hurdle for the government to clear. Bailey's intent "was the sole issue in the case," said the majority, and "the government's case against Bailey [without the SEC complaint] was weak."[21] Hence the majority's conclusion that the error in admitting the complaint was not harmless. But after a retrial that lasted only two days, a jury once again convicted Bailey of the same two counts of illegally selling unregistered securities. The majority's decision ultimately did not benefit Bailey, but it still stands as precedent for litigators to use as an effective shield against the admission of evidence of their clients' alleged prior misconduct. ⊙

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Endnotes

[1]*United States v. Bailey,* 696 F.3d 794 (9th Cir. 2012).

[2]17 C.F.R. § 239.16b.

[3]*United States v. Tarallo,* 380 F.3d 1174, 1187-88 (9th Cir. 2004); *United States v. English*, 92 F.3d 909, 914-15 (9th Cir. 1996).

[4]*Old Chief v. United States,* 519 U.S. 172, 186-87 (1997).

[5]*Bailey,* 696 F.3d at 799-802, 805.

[6]*Bailey,* 696 F.3d at 805, 807 (Smith, J., dissenting).

[7]*See, e.g., United States v. Dupree,* 706 F.3d 131, 137-38 (2nd Cir. 2013) (in federal criminal bank fraud case, TRO in related state civil lawsuit prohibiting defendant from diverting funds was admissible nonhearsay because offered not for the truth of its assertions, but only as evidence that, when defendant withdrew money, he knew of and intended to violate contractual obligation to maintain funds at victim bank).

[8]*Bailey,* 696 F.3d at 802.

[9]LaFave, W.R., Criminal Law § 3.5 (4th Ed. 2003).

[10]*Bailey,* 696 F.3d at 808 (Smith, J., dissenting).

[11]*United States v. Bailey,* 444 U.S. 394, 404 (1980); *see also Kawaauhau v. Geiger,* 523 U.S. 57, 61-62 (1998) (intentional torts generally require that the actor intend the consequences of an act, not simply the act itself).

[12]*Bailey,* 696 F.3d at 807-08 (Smith, J., dissenting).

[13]*Bailey,* 696 F.3d at 801.

[14]*See, e.g., United States v. Morales,* 720 F.3d 1194, 1201 (9th Cir. 2013) (analyzing whether government immigration forms improperly admitted under business records hearsay exception nonetheless were admissible under public records exception); *United States v. Alexander,* 48 F.3d 1477, 1487 (9th Cir. 1995) (document properly admissible under one hearsay exception even though district court admitted it under a different exception).

[15]17 U.S.C. § 504(c)(2).

[16]*Island Software and Computer Service, Inc. v. Microsoft Corp.,* 413 F.3d 257, 263 (2nd Cir. 2005).

[17]*United States v. Pomponio,* 429 U.S. 10, 12-13 (1976).

[18]The few court decisions that have cited *Bailey* typically have done so for basic statements of evidentiary law, such as to state the Ninth Circuit's four-prong Rule 404(b) test, *see, e.g., United States v. Ramos-Atondo,* 732 F.3d 1113, 1123 (9th Cir. 2013), or to state the rule that the erroneous admission of evidence is subject to harmless error review, *see, e.g., Estate of Barabin v. AstenJohnson, Inc.,* 740 F.3d 457, 464 (9th Cir. 2014).

[19]*United States v. Brandon,* Appellant's Opening Brief, 2013 WL 6407985 at *47-*52 (9th Circuit, Nov. 27, 2013).

[20]*Tarallo,* 380 F.3d at 1188.

[21]*Bailey*, 696 F.3d at 805.