LEGAL UPDATE

CLIENT NEWSLETTER OF
CARR, MORRIS & GRAEFF, P.C.

**8300 BOONE BLVD
SUITE 250
TYSONS CORNER
VIENNA, VIRGINIA
22182
(703)288-2900**

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CRIMINAL
WHITE COLLAR DEFENSE: THE "HONEST SERVICES" FRAUD STATUTE

Whoever coined the phrase "the devil is in the details" certainly would have reveled in a recent U.S. Supreme Court decision concerning prosecution of "white collar" criminal defendants. On June 24, 2010, the Supreme Court rendered a decision in *Skilling v. United States*, 561 U.S. ___ , 130 S.Ct. 2896 (2010) which significantly alters how the government will prosecute white collar criminal conduct in going forward. The decision arose in the aftermath of the Enron Corporation financial scandal and collapse in which countless investors lost millions of dollars based on the illegalities perpetrated by Enron executives. Specifically, Jeffrey K. Skilling, former chief executive officer of Enron, was convicted by a federal jury in Houston, Texas on a variety of counts of security fraud, insider trading, false representations to auditors and conspiracy to commit security fraud and wire fraud. A portion of the government's prosecution and Skilling's conviction was for conspiracy to commit wire fraud based on allegations that Skilling had defrauded Enron and Enron's investors and shareholders of his honest services in violation of 18 U.S.C. §1346 by artificially inflating Enron's stock price and by misrepresenting

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INCOME TAXES
LOOK BEFORE YOU LEAP TO ROTH RETIREMENT PLANS

Individual Retirement Accounts ("IRA's"), 401(k)'s, 403(b)'s, the Federal Thrift Savings Plan and the like are all Defined Contribution retirement plans. 26 U.S.C. § 414(i) specifies a Defined Contribution plan as a "plan which provides for an individual account for each participant and for benefits based solely on the amount contributed to the participant's account, and any income, expenses, gains and losses, and any forfeitures of accounts of other participants which may be allocated to such participant's account." For purposes of this article, such plans will simply be referred to as "Retirement Plans." Retirement Plans have the advantages that any funds contributed to the plan receive certain tax advantages (tax-deferred or tax-free growth) and, if employer-sponsored, the participant's employer can contribute additional funds on the participant's behalf as part of a *matching* program.

Each retirement plan has its own rules regarding tax advantages, contribution limits and eligibility which can change from year to year. For instance, in 2010 a participant covered by a 401(k) plan through his employer may contribute up to $16,500 of his salary to the plan ($22,000 for a participant age 50 or older as a *catch-up* contribution) plus any additional *matching* amounts. This is likely old news for working individuals.

The tax advantages of Retirement Plans come in two flavors: Traditional (tax-deferred growth) and Roth (tax-free growth). Any amount contributed to a *Traditional* Retirement Plan is deducted from current income for income tax purposes, grows tax-free while in the plan, and then is taken into current income for income tax purposes once distributed from the plan. Any amount contributed to a *Roth* Retirement Plan receives no tax deduction at contribution, grows tax-free while in the plan, and then is excluded from taxable income once distributed from the plan. The apparent conclusion for most is that, if we expect income tax rates to be higher in the future, then we should always choose the Roth option and *pre-pay* our income taxes now while rates are lower. I will show why this is the wrong conclusion to draw for most of us.

For a long time the Traditional Retirement Plan was the only game in town. The Roth IRA was established by the Taxpayer Relief Act of 1997. Its influence has been mitigated by income-based eligibility limits and conversion options, and small contributions limits. Three recent events, however, have greatly expanded access to Roth Retirement Plans. First, under the Tax Increase Prevention and Reconciliation Act of 2005, starting in 2010, individuals, *regardless of income*, are allowed to convert Traditional IRA's (including Rollover IRA's from other Retirement Plans) into Roth IRA's. When doing a Roth IRA conversion, the individual takes the conversion amount into income during the year of conversion[1] and the amount converted into the Roth IRA is then allowed to grow tax-free. Converting now means paying taxes now (*i.e.*., locking into the current tax rates) and being able to withdraw the converted money tax-free from the Roth IRA once reaching retirement age. Second, under the Economic Growth and Tax Relief Reconciliation Act of 2001, starting on January 1, 2006, employers have been free to amend their 401(k) plan to allow employees to elect Roth tax treatment for Retirement Plan contributions. Many employers have chosen to add the Roth 401(k) option. Third, the Small Business Jobs Act of 2010, signed September 27, 2010, includes a Roth 401(k) conversion provision. Clearly, the trend is toward Roth Retirement Plans.

To Roth or not to Roth…. Tax rates are a moving target, but the expectation is that tax rates will rise over time to meet budget shortfalls. If the marginal tax rate during retirement is the same as it is while working, the Traditional and Roth Retirement Plans are equivalent. We do not know what future tax rates will be, let alone what any individual's specific marginal rates will

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The articles in this publication are designed to give general information on the matters covered. Space limitations prevent exhaustive treatment or analysis of any topic. The articles are not intended to substitute for advice on specific legal problems.

NEGLIGENCE
COURT ADDRESSES SCOPE OF ONE-PARTY RELEASE

It is not uncommon for a Plaintiff in a negligence case to name multiple parties as defendants. The pre-filing investigation and post-filing discovery process help sort out the liability issues, sometimes even identifying a sole liable party. More typically, the named defendants act in their own interest—pointing blame elsewhere or striking a favorable deal at a time of their choosing. The process becomes more complicated when releases are drafted and the non-settling defendant(s) recoils at the thought of an empty chair at defense table.

In a recent case in U.S. District Court for the District of Columbia, *Sibert-Dean v. WMATA v. Woodson*, D.D.C. C.A. No. 08-2145, Judge Ricardo Urbina addressed a situation of conflicting interests among defendants. The case arose from a three-vehicle collision in Washington. Plaintiff, a Metrobus passenger, was injured when the bus and a car driven by Ms. Woodson collided. Plaintiff reached an out-of-court settlement with Woodson's insurance carrier, then filed suit against WMATA in D.C. Superior Court. WMATA removed the case to federal court and sued the driver of the car for *contribution.* Ms. Woodson moved for summary judgment, arguing in essence that she cannot be liable because she had been released by the Plaintiff-victim.

Judge Urbina denied Woodson's motion for summary judgment because her liability for Plaintiff's injuries had not been proven or stipulated. Under D.C. law there is a right of contribution among joint tortfeasors. A non-settling defendant (WMATA here) who is found liable is entitled to a *pro rata* credit based on the non-settling right of contribution from the settling tortfeasor (Woodson). In this instance there was no stipulation of Woodson's liability for Plaintiff's injuries, so WMATA is entitled to keep Woodson in the case in order to prove her liability.

The court's ruling does not expose Woodson to further liability to Plaintiff; that is, Woodson will not have to pay damages, even if she is found to be solely liable. But if Woodson is found liable as a joint tortfeasor, WMATA can claim a *pro rata* (50%) credit against any judgment rendered.

LAWRENCE CARR

COMMENTARY
ARE LAWYERS USEFUL?

William J. Baumol is a retired Princeton economics professor and probably the best economist yet to win a Nobel Prize. He has made substantial contributions to the role of the entrepreneur in economic growth, economic history, operations research, the theory of contestable markets, the service sector cost disease, and many other practical problems in microeconomics. In 2002 Baumol published a book titled *The Free-Market Innovation Machine: Analyzing the Growth Miracle of Capitalism* in which he made the following remarkable statement, worth quoting in full:

> I have sometimes asserted that there is no occupation whose *total economic product is greater than that of lawyers* . . . A strong case can be made for the conclusion that without the rule of law, including the rights of property and the enforceability of contracts, the growth miracle of capitalism, *indeed capitalism itself*, might not have been possible. [Page 68, emphasis supplied].

In Baumol's view the high economic productivity (and hence high living standard) in Western European countries, the U.S., and other nations with similar socio-economic institutions is owed to four factors: first, heavy investment in education, research, and development; second, continuous and constant commercialization of inventions and innovations; third, a market economy; and, last but not least, the rule of law. Because of the rule of law, capitalism provides entrepreneurs with incentives "to channel their activities in productive directions, rather than, as in many other forms of economic organization, in directions that contribute little to output growth or even impede it."

Baumol states,

> [T]here is a variety of roles among which entrepreneurs' efforts can be reallocated. And some of those roles do not follow the constructive and innovative script that is conventionally attributed to them. *How entrepreneurs act at a given time and place depends heavily on the prevailing "rules of the game" – i.e., the reward structure of the economy. My central hypothesis is that it is this set of rules, and not the supply of entrepreneurs, that undergoes significant changes from one period to another, and helps to dictate the ultimate effect on the economy via the allocation of entrepreneurial resources.* [Page 61, emphasis supplied].

In plain English, then, there are a number of legal institutions in a free-market capitalist society which force the entrepreneur to channel his or her activities in a constructive direction: rights of property, most importantly in this day and age, intellectual property (90% of economic growth is accounted for by scientific and technological advances); enforceable contracts, including those for licensing intellectual property; impartial and, it is hoped, honest judges, juries, and administrative agencies to administer the legal system; and, of course, ordinary lawyers working in the vineyards of private, corporate, or government practice.

Baumol continues,

> Capitalism itself was precluded by absence of the rule of law. It requires markets in which the participants can have confidence in any agreements arrived at. It is driven by the pursuit of accumulated and retainable wealth and opportunities to expand that wealth by devoting it to the production process. *That is why, without the contribution of lawyers, the free-market economies might never have evolved. And even if they had, it is unlikely that their unprecedented growth could have occurred. It is on these grounds that I base my evaluation of the enormous total contribution of lawyers to the performance of the industrial economies.* [Page 69, emphasis supplied].

Baumol also quotes from the work of David S. Landes, a retired Harvard economic historian, who has stressed the Industrial Revolution originated in Britain because Britain had developed (through trial and error) the following institutional attributes for a growth economy: secure private property to encourage saving and investment, secure rights of personal liberty, enforced rights of contract, and stable, honest, and responsive government.

Critics and opponents of free-market capitalism point to the 2008 banking meltdown and the subsequent deep recession as evidence for the malignancy of markets. But, the financial crisis was not an instance of market failure but rather one of *legal* failure where the legal rules designed to keep our banks on an even keel were disregarded. Bank examination went out the window and fraud permeated mortgage origination, securitization, and marketing. In short, for markets to work well and efficiently, the legal framework in which markets operate must also function effectively.

To sum up, without entrepreneurs there would be no capitalism or economic growth. It appears from the latest economic thinking, however, that without effective lawyering we would still be backward economically. So, are lawyers useful? The answer seems to be yes.

NÉSTOR CRUZ

CRIMINAL

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the company's financial status.

By way of background, 18 U.S.C. §1346 was enacted by Congress in 1988 to provide definition and meaning to the federal mail fraud and wire fraud statutes, 18 U.S.C. §1341 and 1343 respectively, each of which contains the term "scheme or artifice to defraud" as an element of the offense. Section 1346 entitled Definition of "scheme or artifice to defraud" states that "For the purpose of this chapter, the term 'scheme or artifice to defraud' includes a scheme or artifice to deprive another of the intangible right of honest services." Prosecutors, over the years, have used the honest services fraud statute to prosecute a variety of corporate wrongs involving undisclosed self dealing by corporate executives to the detriment of both the corporation and its shareholders while providing a financial benefit to those directly involved in the self dealing. For example, in the *Skilling* case, the indictment alleged, among other things, that Skilling and other co-conspirators engaged in a scheme to deceive investors by manipulating Enron's financial data and reports and by making false and misleading statements while at the same time enriching themselves through increased salaries, bonuses and other financial benefits. As a result of this conduct, part of the indictment and conviction of Skilling was for conspiracy to commit securities and wire fraud by depriving Enron and its investors and shareholders of their right to receive his honest services pursuant to §1346. Significantly, while there were allegations and proof that Skilling and his co-conspirators were financially enriched in the form of increased compensation and financial benefits based on their various misrepresentations, there were no allegations or proof that Skilling received an actual bribe or kickback from a third party which directed his services. Herein lies the devil in the detail.

On appeal to the U.S. Court of Appeals for the Fifth Circuit, one of the issues raised concerned the honest services §1346 conviction with Skilling arguing that at a minimum a §1346 conviction required a determination that he acted for private gain which was distinct and apart from regular financial compensation and that without a showing that he received gain in the form of kickbacks or bribes, his conviction lacked the element of a *corrupt pursuit of private gain* required by §1346. Skilling's conviction was upheld by the Fifth Circuit whereupon he appealed to the Supreme Court with one of the issues again being whether a §1346 conviction requires that the defendant's conduct be with the intent to achieve private gain above and beyond ordinary compensation and whether the honest services statute was so vague that it violated the Due Process Clause of the Fifth Amendment.

The Supreme Court, in a majority opinion written by Justice Ginsburg, joined by five other justices, rejected the vagueness argument but did significantly limit the reach of 18 U.S.C. §1346 to cases "involving fraudulent schemes to deprive another of honest services through bribes or kickbacks supplied to a third party who had not been deceived." The Court held that as the government had never alleged that Skilling accepted such third party payments in exchange for his Enron misrepresentations, he did not commit honest services fraud in violation of §1346. In so holding, the Court did not eliminate the government's ongoing use of §1346 honest services prosecutions, but it did reject the future use of §1346 as a prosecutorial tool concerning "undisclosed self- dealing "situations where the corporate officer is, without more, acting for self benefit rather than for the benefit of the corporate entity and its shareholders.

STEPHEN GRAEFF

INCOME TAXES

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be. If the marginal tax rate is *higher* while working than during retirement, though, a participant is better off contributing to a Traditional Retirement Plan. If the current marginal tax rate is *lower* while working than during retirement, a participant is better off contributing to a Roth Retirement Plan. But this only applies to the ***marginal dollar***, the last dollar off the top that you contribute to your Retirement Plan. The story does not end here.

The U.S. Income Tax system is progressive, meaning that income is taxed at higher rates the more you make. As an example, for a married couple filing jointly in 2008 (the "Smiths"), the first $17,900 of income is not taxed at all, due to deductions and exemptions. The next $16,050 is taxed at 10%, the next $49,050 at 15%, the next $17,000 at 25%. Suppose, the Smiths had taxable income of $100,000 during 2008, their *marginal* tax rate was 25%, but their *effective* tax rate was 13.2%. If John Smith contributes $5,000 to a Traditional Retirement Plan in 2008 while working he avoids paying 25% tax on the $5,000 contributed. Using 2008 tax brackets, assume the Smiths have the same $100,000 income during retirement (comprised entirely of withdrawals from a Traditional Retirement Plan), the effective tax rate applied to those withdrawals is 13.2%. By choosing a Traditional Retirement Plan, John Smith paid no tax on money contributed and paid 13.2% tax on withdrawals. Had he chosen a Roth Retirement Plan, he would have paid a 25% tax rate on contributions. The Traditional Retirement Plan is the winner[2]. The dollars contributed to Traditional Retirement Plans come off the top decreasing income at your *marginal* tax rate. In retirement, income fills in from the bottom filling out the lower tax brackets first – the *effective* tax rate is always lower than the *marginal* tax rate in a progressive system, provided you are not in the lowest tax bracket, in which case they are equal. So, unless you expect elimination of a progressive income tax system, a dramatic rise in marginal rates, or if you anticipate having higher income in retirement than when working (an unlikely but intriguing scenario), a Traditional Retirement Plan is likely the right choice for many of us.

Every individual's tax planning needs are unique, and you should consult with your tax professional where unsure. Roth Retirement Plans have certain benefits which have not been addressed here. Consider and discuss the foregoing before choosing a Roth Retirement Plan over a Traditional plan, or completing a Roth IRA conversion. All else being equal, taxes are a bouncing ball (is a VAT or other consumption tax in our future?) and taking the tax advantage now is preferable to the expectation of one in the future.

JUSTIN BANFORD

[1] For 2010 Roth IRA conversions, the IRS has granted the option to claim 50% of the conversion amount as income in 2011 and the remaining 50% in 2012, spreading out the tax burden.

[2] Assume the contribution quadruples while in the plan. Traditional = $5,000 grows into $20,000, then taxed at effective rate of 13.2% on distribution = $17,360. Roth = $5,000 taxed at marginal rate of 25%, ($5,000*75%) then quadruples in the plan = $15,000.

CARR, MORRIS & GRAEFF, P.C.

Carr, Morris & Graeff, P.C., was established in 1982 by the named principals—Lawrence Carr, Roy Morris and Stephen Graeff. It is a diversified firm structured primarily to meet the legal needs of businesses and their principals.

The firm strives to provide full service representation to its corporate and individual clients. It is designed to provide such service by organization and presentation of an array of attorneys with diverse backgrounds in specialized areas of the law as well as a generalized background which enables them to look beyond a narrow specialty or need. The academic and cultural backgrounds of the attorneys of the firm are as diverse as their experience and specializations.

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The firm maintains its office in Tysons Corner, Virginia—the business hub of the metropolitan region. It has attorneys admitted to all of the local judicial jurisdictions.

STAFF NOTES

Néstor Cruz helped organize the Fall Cornell Alumni Club lunch. His guest was Christina Scheppelmann, artistic director of the Washington Opera.

* * *

Néstor and Margarita Cruz spent Thanksgiving break in France. While in Paris they attended a performance of "Mathis der Maler" at the Opéra Bastille.

* * *

Phil Schwartz and his playing partner, Dana Eddy, won the season closing Fall Classic Member-Member golf tournament at Springfield Golf & Country Club. The duo had to work overtime to close the deal. After 36 holes of regulation play, the top four teams participated in a sudden death alternate shot shootout. Phil's par putt on the second playoff hole proved to be the winner. *Sorry, but Phil's putt was not an 18-foot double breaker…. It was a tap-in, which Dana claims Phil almost missed.*

* * *

NOT AGAIN! The Universe again spoke to Roy Morris, reminding him that racing motorcycles is for young men who don't break when they fall down. This time it was the right shoulder. With gentle urging from Marie, Roy has decided to sell his race bike and confine his motorcycling to cruising the back roads.

* * *

Holiday needs. Drunken holiday office parties are so very 1960's. As you develop your more dignified and sedate holiday event, imagine the fun of sponsoring a group blood donation! The American Red Cross can help: 1-800-GIVE-LIFE.

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