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Forfeiture: A Primer on Proceeds

By Gary Stein

The U.S. Court of Appeals for the Second Circuit has become the second court of appeals to reject the government's broad interpretation of the statute defining "proceeds" for purposes of federal forfeiture proceedings. Agreeing with the Tenth Circuit, the Second Circuit held in a pair of securities fraud cases last month that the defendants could only be ordered to forfeit the net profits they received, not the gross revenues generated by the offense. *United States v. Contorinis,* ___ F.3d ___, 2012 WL 3538270 (2d Cir. Aug. 17, 2012); *United States v. Mahaffy*, ___ F.3d ___, 2012 WL 3125209 (2d Cir. Aug. 2, 2012).

The Second Circuit's decisions furnish an occasion to review the state of the "proceeds" statute, 18 U.S.C. § 981(a)(2), a dozen years after its enactment as part of the Civil Asset Forfeiture Reform Act of 2000 (CAFRA). As the Supreme Court has observed, "proceeds" is an inherently ambiguous word. *United States v. Santos,* 553 U.S. 507, 511 (2008). While § 981(a)(2) presumably was intended to limit that ambiguity, Congress' somewhat unusual choice of wording has instead spawned a host of interpretive difficulties, which have divided courts and done little to clarify what "proceeds" means in a particular case.

The Statutory Definition

CAFRA greatly expanded the list of crimes for which forfeiture of proceeds is available under federal law. Section 981(a)(1)(C) provides for forfeiture of "[a]ny property, real or personal, which constitutes or is derived from proceeds" traceable to a violation of 33 specified Title 18 offenses; any "specified unlawful activity" as defined in 18 U.S.C. § 1956(c)(7) — which encompasses more than 250 predicate offenses; or a conspiracy to commit any of those crimes. The statute applies in virtually all federal forfeiture proceedings except those in drug cases.

The definition of "proceeds" in § 981(a)(2) provides courts with two principal alternatives:

(A) In cases involving illegal goods, illegal services, unlawful activities, and telemarketing and health care fraud schemes, the term "proceeds" means property of any kind obtained directly or indirectly, as the result of the commission of the offense giving rise to forfeiture, and any property traceable thereto, and is not limited to the net gain or profit realized from the offense.

(B) In cases involving lawful goods or lawful services that are sold or provided in an illegal manner, the term "proceeds" means the amount of money acquired through the illegal transactions resulting in the forfeiture, less the direct costs incurred in providing the goods or services.

Although entitled "Civil forfeiture," 18 U.S.C. § 981 does not apply only in civil forfeiture actions. By operation of 28 U.S.C. § 2461(c), it also can apply to forfeiture proceedings in criminal cases. Thus, § 981(a)(1)(2)'s definition of proceeds is controlling in almost all non-drug cases in which the government seeks civil or criminal forfeiture of proceeds of criminal activity.

'Unlawful Activities'

In essence, § 981(a)(2)(A) broadly authorizes forfeiture of what is sometimes called gross receipts, whereas forfeiture under § 981(a)(2)(B) is limited to net profits. Distinguishing subsection (A) cases from subsection (B) cases is, therefore, central to the statute's operation.

The first case to address this issue was *United States v. All Funds on Deposit in United Bank of Switzerland*, 188 F. Supp. 2d 407 (S.D.N.Y. 2002). Deeming "unlawful activities" in subsection (A) to be a "term of art," All Funds held that it encompassed all offenses constituting a "specified unlawful activity" as defined in 18 U.S.C. § 1956(c)(7). Consequently, the court rejected the claimant currency exchange company's argument that, by illegally transferring customer funds to Iran, it was merely providing a "lawful service" (currency exchange) in an "illegal manner," triggering subsection (B). The court found the amount of money transferred to be proceeds, rather than the currency house's vastly smaller profits from the transfers.

All Funds has not been well received. It was initially rejected in *United States v. Kalish,* 2009 WL 130215 (S.D.N.Y. Jan. 13, 2009). Kalish reasoned that if Congress had intended subsection (A) to automatically reach all forms of "specified unlawful activity," it would have used "that precise term," instead of the "looser" term "unlawful activities." Moreover, the All Funds reading rendered subsection (B) "nugatory" because almost every predicate crime listed in § 981(a)(1)(C) is a "specified unlawful activity," leaving only a handful of statutes (i.e., those involving counterfeiting, forgery, explosive materials and fraudulent identification documents) within the possible scope of subsection (B).

Shortly thereafter, the Tenth Circuit, in United *States v. Nacchio*, 573 F.3d 1062 (10th Cir. 2009), endorsed the Kalish court's reasoning, similarly concluding that the mere fact that the crime in question is a "specified unlawful activity" does not "automatically" render it an "unlawful activity" under subsection (A). With its decisions in Contorinis and Mahaffy, the Second Circuit has now also embraced this view, after finding that the government's and All Funds' reading renders subsection (B) "essentially meaningless."

If it does not incorporate the term "specified unlawful activity," what does

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"unlawful activities" as used in subsection (A) mean? Read literally, it would swallow subsection (B) whole, since every forfeiture case necessarily involves "unlawful activities" of one kind or another. Such a literal reading would be absurd and contrary to Congress' intent in creating subsection (B). According to the Second and Tenth Circuits, the phrase "unlawful activities" instead means "inherently" unlawful activities, such as robbery or the sale of foodstamps, which cannot be done lawfully.

'Illegal' Versus 'Lawful' Goods and Services

The question remains: how to differentiate cases involving "illegal goods" and "illegal services" under subsection (A) from those involving "lawful goods" and "lawful services" that are "sold or provided in an illegal manner" under subsection (B)?

Most courts have approached this question by asking whether the criminal activity involved can normally be performed in a lawful manner. For example, in Nacchio, which involved insider trading, the Tenth Circuit reasoned that, because "securities themselves are generally lawful," the securities at issue were "lawful goods" sold in an "illegal manner," triggering application of subsection (B).

The Second Circuit in Mahaffy came to the same conclusion. The alleged scheme in that case involved stockbrokers who provided purportedly confidential customer order information to a day-trading firm that then traded in securities in advance of the brokerage firms' customers, in a practice known as "frontrunning." Because "[t]rading those securities, as a general matter, is not unlawful," the court held that subsection (B) would apply and that the proper measure of forfeiture would be each stockbroker's net, not gross, gain. Two weeks later, the Second Circuit reaffirmed that conclusion in Contorinis, an insider trading case, holding squarely that "[t]he definition of proceeds for insider trading violations is" governed by subsection (B).

Similarly, the court in In re 650 Fifth Avenue & Related Prop., 777 F. Supp. 2d 529 (S.D.N.Y. 2011), applied subsection (B) because transferring funds, managing business affairs and real estate investments, and running a charitable organization are "normally legal activities," but were only alleged to be illegal in that case because they were performed for the Iranian government. (However, 650 Fifth Avenue also held that, insofar as the underlying criminal activity consisted of concealing ownership of assets from a judgment creditor, subsection (A) applied because such conduct "is never a legal activity.")

Other circumstances in which courts have applied subsection (B) include: procuring government contracts through bribery for work which was not inherently illegal (*United States v. St. Pierre*, 809 F. Supp. 2d 538 (E.D. La. 2011)); a foreclosure consulting business that fraudulently filed bankruptcy petitions so as to illegally delay foreclosure sales (*United States v. Blechman*, 2010 WL 235035 (D. Kansas Jan. 8, 2010)); and a fraudulent advance fee scheme engaged in by an unlicensed entity (Kalish).

But other courts have viewed the matter differently. These courts appear to equate fraud with illegal goods or services. As a result, they have found subsection (A) applicable and ordered the defendant to forfeit the gross receipts from the fraudulent scheme. *See United States v. Warshak*, 631 F.3d 266 (6th Cir. 2010) (applying subsection (A) to herbal supplement company's scheme to defraud customers and banks); *United States v. Farkas*, 2011 WL 5101752 (E.D. Va. Oct. 26, 2011) (applying subsection (A) to mortgage fraud scheme); *United States v. Schlesinger*, 396 F. Supp. 2d 267 (E.D.N.Y. 2005) (applying subsection (A) to food stamp fraud). However, these decisions tend to assume rather than analyze the applicability of subsection (A). To the extent they rest on the premise that a fraudulent scheme necessarily involves an illegal good or service, that premise is questionable in light of the discussion above.

Perhaps less controversially, courts have also applied subsection (A) to cases involving the sale of contraband cigarettes. See *United States v. Noorani*, 188 Fed. Appx. 833 (11th Cir. 2006); *United States v. Funds* from First Regional Bank Account, 639 F. Supp. 2d 1203 (W.D. Wash. 2009). Contraband would seem to be a relatively clear-cut example of an "illegal good."

Limiting Proceeds Forfeitures

By rejecting knee-jerk application of § 982(a)(2)(A) in almost all instances, the courts have been able to scale back government forfeiture requests that appear to go beyond the proper purposes of forfeiture law.

In Mahaffy, for example, the government sought forfeiture of the gross commissions paid to the defendant brokers' firms, even though 70% of the commission payments went to the brokerage firms rather than the brokers themselves, and even though the firms were not alleged to have been co-conspirators in the scheme. (On the contrary, they were the scheme's purported victims). Believing that subsection (A) applied, the district court ordered forfeiture of the gross commissions. But based on its determination that subsection (B) applied instead, the Second Circuit limited any forfeiture to the portion of the commissions that the brokers actually received.

In Contorinis, the government sought and obtained in the district court a $12.65 million forfeiture order, representing the total amount of profits made, and losses avoided, by the hedge fund on whose behalf the defendant engaged in insider trading. Reversing this order, the Second Circuit agreed with the defendant, who was an employee and small equity owner of the fund, that he could not be ordered to forfeit profits that he never received or possessed. To be forfeitable, the court held, the property "must have, at some point, been under the defendant's control or the control of his co-conspirators in order to be considered 'acquired' by him" under § 982(a)(2)(B). A contrary result "would be at odds with the broadly accepted principle that forfeiture is calculated based on a defendant's gains."

Similarly, in St. Pierre, the government sought forfeiture of the total amount of billings paid under a subcontract for the City of New Orleans procured by bribery, even though the defendant was only a 25% owner of the contracting entity and his business partners were not alleged to have been co-conspirators. While acknowledging that the revenues were in some sense generated through the illegal transactions resulting in the forfeiture, the court held that "on these facts it is unreasonable and inconsistent with the purpose of forfeiture to require St. Pierre to forfeit funds that he neither directly [n]or indirectly acquired" under § 982(a)(2)(B), and limited the forfeiture to 25% of the billings.

Conclusion

In light of § 981(a)(2)'s inherent ambiguities, it has fallen upon the courts to interpret the statute in a manner not only consistent with the statutory text, but also congruent with the underlying purpose of forfeiture. This has led most courts to adopt a fact-intensive approach to the definition of "proceeds" that has succeeded, in many instances, in placing limits on overly aggressive demands for forfeiture by prosecutors.

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