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December 14, 2015

United States v. *Litvak*

Second Circuit Holds That Bond Trader's Misstatements About Pricing Are "Material" Under Section 10(b), Permits Defendant to Offer Extensive Expert Testimony

SUMMARY

On December 8, 2015, the Second Circuit issued its decision in *United States* v. *Litvak*, which reversed the defendant's conviction and remanded the case for a new trial. Notwithstanding the reversal, the Court reaffirmed the "longstanding principle" that Section 10(b) of the Securities Exchange Act of 1934 is to be construed "flexibly," and held that misstatements that might otherwise be considered "seller's talk," when viewed through the lens of the federal securities laws, may be material and can result in criminal liability.[1]

Jesse C. Litvak was a securities trader at Jefferies & Company. The government charged that Litvak made misstatements during negotiations with counterparty-funds that were owned in part by the U.S. Department of the Treasury—represented by professional investment managers—for the purchase or sale of residential mortgage-backed securities ("RMBS"). At trial, the government offered evidence that Litvak (1) told sellers of certain RMBS that Jefferies had agreed to resell those RMBS for less than it actually had, arguably reducing the price Jefferies paid; (2) told purchasers of certain RMBS that Jefferies had paid more for those RMBS than it actually did, arguably increasing the sale price Jefferies received; and (3) told purchasers of certain RMBS that he was a mere middleman between the purchaser and an unnamed third-party seller, though no such third-party seller actually existed because Jefferies was the true owner of the RMBS.[2] Litvak did not misrepresent the quality or nature (*e.g.*, structure or risk profile) of the RMBS.

After a trial in the United States District Court for the District of Connecticut, a jury convicted Litvak of fraud against the United States, making false statements, and committing securities fraud in violation of Section 10(b).[3] Litvak was sentenced principally to 24 months' imprisonment.

On appeal, Litvak advanced four points:

- *First*, he argued that his misstatements were not material to the Treasury, and, as such, that his convictions for fraud against the United States and making false statements were improper.[4] The Treasury was a limited partner in certain Public-Private Investment Funds ("PPIFs"), and these PPIFs invested in certain RMBS sold by Litvak, allegedly on the basis of Litvak's misstatements concerning those RMBS.[5] The Second Circuit acknowledged that the government "ha[d] established that Litvak's misstatements may have been *relevant* to the Treasury" due to the Treasury's interest in maximizing its return on investment, but held that the Treasury, due to its status as a limited partner, lacked the authority to influence decisions concerning which RMBS the PPIFs purchased and at which price they purchased them.[6] Because the government failed to identify any decision of the Treasury that Litvak's misstatements could have influenced, the Second Circuit reversed Litvak's conviction for fraud against the United States and making false statements.[7]
- *Second*, Litvak argued that his misstatements were not material as a matter of law "because they did not relate to the bonds' value (as opposed to their price)."[8] Litvak contended that only misstatements that bore on the quality or nature of the securities could be material and, based upon Second Circuit authority from *Feinman* v. *Dean Witter Reynolds, Inc.*, 84 F.3d 539 (2d Cir. 1996), argued that courts "reject the idea that misstatements about how a price is derived can be material merely because they affect negotiations."[9] The Second Circuit disagreed.[10] Under Section 10(b), an alleged misstatement is material where there is "a substantial likelihood that a reasonable investor would find the . . . misrepresentation important in making an investment decision."[11] Acknowledging the "longstanding principle" that Section 10(b) should be construed "flexibly" in order to effectuate its purpose—"remedying deceptive and manipulative conduct with the potential to harm the public interest or the interests of investors"—the Second Circuit held that a rational jury could conclude that Litvak's misstatements were material.[12] Important to the Court's decision was the testimony of representatives of various counterparties in Litvak's transactions that Litvak's misrepresentations were "important to them.[13]" According to the Court, that testimony "preclude[d] a finding that no reasonable mind could find Litvak's statements material."[14]
- *Third*, Litvak argued that the district court erred in not instructing the jury that proof of "'contemplated harm' (or 'intent to harm')" was required to sustain a conviction under Section 10(b).[15] The Second Circuit explained that, although the mail and wire fraud statutes do require proof of such contemplated harm or intent to harm, the government's burden is lower under the Exchange Act, which requires only "an intent to deceive, manipulate or defraud."[16] Accordingly, the district court did not err in its jury charge.
- *Fourth*, Litvak argued that the district court improperly excluded "certain portions of his experts' proposed testimony" concerning the materiality of Litvak's alleged misstatements.[17] The Second Circuit concluded that some of the excluded expert testimony—testimony describing the process by which investment managers value RMBS, and the irrelevance of Litvak's misstatements to that process—could have allowed a jury to find that Litvak's misstatements were immaterial.[18] Despite holding that the improper exclusion of one portion of one expert's proposed testimony was sufficient to vacate Litvak's conviction for securities fraud, the Second Circuit reviewed the district court's decisions excluding other proffered testimony and held that Litvak had the right to introduce some—but not all—of it.[19] Because Litvak's proffered testimony was excluded, and that exclusion was not harmless, the Second Circuit remanded for a new trial to allow certain of the previously excluded expert testimony.

IMPLICATIONS

In its opinion, the Court defined a material misrepresentation as one that a reasonable investor would find "important."[20] This low bar, which the government will likely have little trouble clearing in many cases, affirms the expansive reach of the federal securities laws, at least within the Second Circuit. Misrepresentations that are sometimes characterized as immaterial "sales talk" or "puffery" are arguably actionable false statements and may result in criminal liability.

Significantly, however, the Court held that defendants may introduce extensive expert testimony bearing on market practices and expectations to refute the alleged materiality of particular misrepresentations.[21] Highlighting this point, the Court found that the district court's improper exclusion of expert testimony bearing on market practices and expectations was *not* harmless.[22] The opinion provides a useful roadmap to future defendants who may wish to offer expert testimony concerning market practice and expectations to establish the lack of materiality of their alleged misrepresentations.

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ENDNOTES

1 *United States* v. *Litvak* ("*Litvak II*"), No. 14-2902, 2015 WL 8123714, *10-11 (2d Cir. 2015).

2 *Id.* at *1-3.

3 *United States* v. *Litvak* ("*Litvak I*"), 30 F. Supp. 3d 143, 146 (D. Conn. 2014) *rev'd in part, vacated in part*, No. 14-2902, 2015 WL 8123714 (2d Cir. Dec. 8, 2015).

4 *Litvak II* at *4.

5 *Id.* at *5.

6 *Id.* at *8 (emphasis in original).

7 *Id.*

8 *Id.*

9 Brief of Defendant-Appellant 19-25, *Litvak II*.

10 *Litvak II* at *9.

11 *Id.*

12 *Id.* at *4, *10.

13 *Id*. at *9.

14 *Id*.

15 *Id.* at *11.

16 *Id.*

17 *Id*. at *12.

18 *Id.* at *12-14.

19 *See id.* at *12-21.

20 *Id*. at *9 n.9.

21 *Id.* at *12-21.

22 *Id.* at *15-21.

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