"Parallel" IRS (and Other) Civil and Criminal Proceedings Now Intersect

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A. Introduction

There is nothing new about a criminal case being followed by a civil suit. But, increasingly, a defendant facing civil proceedings will also be subjected to parallel (and often simultaneous) criminal proceedings. This includes not only parallel IRS civil audits and criminal investigations – a focus of this article – but also parallel proceedings in many other areas, involving civil and criminal investigations, civil complaints and indictments. In some instances, the government's conduct of parallel investigations may be straightforward and aboveboard, but in others, the criminal investigation may be furtive and conducted entirely in the background. Cases narrowly construing Fifth Amendment and due process protections have increased the government's ability to conduct parallel proceedings, and revisions to the Federal Rules of Evidence have increased their usefulness. This article will survey some of these developments and discuss new policies and legislation that reflect the government's growing appetite for parallel proceedings.

B. Background

The potential for parallel proceedings was recognized as early as 1912, when the Supreme Court found that "an imperative rule that the civil suit must await the trial of the criminal action might result in injustice." Standard Sanitary Manufacturing Co. v. United States, 226 U.S. 20, 52 (1912). More recently, the Court held in United States v. Kordel that using evidence obtained in a civil investigation for subsequent prosecution of criminal charges is permissible as long as there is no "violation of due process or a departure from proper standards in the administration of justice." 397 U.S. 1, 11 (1970).

Judicial approval aside, enforcement agencies have long understood the strategic complications that parallel proceedings present. In 1960, for example, the IRS published Policy Statement P-4-84, which commented, "Experience has demonstrated that attempts to pursue both the criminal and civil aspects of a case concurrently may jeopardize the successful completion of the criminal case." See I.R.M. 1.2.1.4.25 (February 4, 1991). The risks include, among other things, disputes over the proper use of the government's information gathering powers, grand jury secrecy issues and prejudice to the rights of the parties. In particular, the risks arising in parallel civil and criminal tax proceedings include disputes over the government's use of the audit process and its civil and criminal investigative tools. Thus, the policy statement provided that once a case was referred for criminal prosecution, the civil investigation was to be deferred until the criminal case was concluded.

Broad discovery opportunities in a civil suit present risks and rewards for both parties involved in a parallel criminal case. The government's risks in the civil suit include the defendant's liberal
access to all relevant information, which conflicts with the much more limited discovery allowed in criminal cases. In the civil case, the defendant may get a "sneak peak" at the government's witnesses and strategies, making it, essentially, practice for the criminal case.

Courts have recognized the potential for abuse. For instance, New Jersey (and, later, United States) Supreme Court Justice William J. Brennan Jr. observed that allowing broad discovery in a criminal case would make the government's task almost "insurmountable." Brennan, The Criminal Prosecution: Sporting Event or Quest For Truth?, 1963 Wash. U. L. Q. 279, 292 (June 1963). Along the same lines, in Founding Church of Scientology of Washington, D.C., Inc. v. Kelley, 77 F.R.D. 378, 380 (D.D.C. 1977), the court wrote, "It is well established that a litigant should not be allowed to make use of liberal discovery procedures applicable in a civil suit to avoid the restrictions on criminal discovery and, thereby, obtain documents he might not otherwise be entitled to for use in his criminal action." The government must also deal with the potential for a civil defendant to assert the Fifth Amendment privilege and the effect a loss in the civil suit would have on the criminal case. Civil discovery may also compromise the identity of a confidential informant. See Campbell v. Eastland, 307 F.2d 478, 487 (5th Cir. 1962), cert. denied, 371 U.S. 955 (1963).

The defendant also faces difficult decisions in parallel proceedings, including whether to cooperate with the civil investigation, and if so, to what extent. The Fifth Amendment right against self-incrimination is a particularly important concern. Cooperating in a civil proceeding in the hope of limiting damages will often require providing otherwise privileged information, making it available for use in a subsequent criminal proceeding. On the other hand, refusing to provide discovery in a civil case may result in the court or jury drawing an adverse inference. See Baxter v. Palmigiano, 425 U.S. 308 (1976). Thus, the only "choice" may be a Hobson's choice.

One mechanism for dealing with these issues is for the court to stay the civil proceeding. Either party, or sometimes third parties, may have a strategic interest in doing so. The court may issue such a stay upon motion from either party, an intervening party or on its own:

The power to stay proceedings is incidental to the power inherent in every court to control the disposition of the causes on its docket with economy of time and effort for itself, for counsel, and for litigants. How this can best be done calls for the exercise of judgment, which must weigh competing interests and maintain an even balance.

Landis v. North American Co., 299 U.S. 248 (1936). Those competing interests include potential prejudice to the government, the defendant, third parties and the court. See Golden Quality Ice Cream v. Deerfield Specialty Papers, Inc., 87 F.R.D. 53 (E.D. Pa. 1980). The Tax Court has no specific rule that authorizes such a stay, though Rule 103(a), authorizing the imposition of protective orders, may provide authority under appropriate circumstances. See also I.R.M. 35.3.9.12 (August 11, 2004) ("A motion for stay of civil proceedings, except in rare and extremely compelling circumstances, should not be filed by respondent" until a case has been referred to the DOJ for criminal prosecution).
C. Shrinking Gap

Despite the risks for both parties, parallel investigations are becoming increasingly common, as reflected in part by several formal government initiatives. In 2002, President Bush established the Executive Fraud Task Force, which aimed to strengthen coordination between civil and criminal enforcement authorities and was headed by members of agencies including the SEC and DOJ. Between 2002 and 2009, Task Force efforts resulted in more than 1,200 corporate fraud convictions. In 2009, President Obama established the Financial Fraud Task Force, which also focuses on coordinated enforcement efforts. Speaking at the announcement of the new task force, the Director of Enforcement at the SEC proclaimed, "In fact, in fiscal year 2009, more than 150 of the SEC's enforcement cases were filed in coordination with criminal charges filed by the DOJ and others, an increase of 30 percent over fiscal year 2008. The Task Force should only increase those numbers, and provide even greater opportunities for close collaboration and information sharing among law enforcement authorities." Robert Khuzami, Remarks at Department of Justice Press Conference (Nov. 17, 2009).

D. Civil Audits and Criminal Enforcement

Parallel civil audits and criminal tax investigations are a relatively new phenomenon, which may reflect the government's intensified effort to use criminal enforcement to help close the tax gap. For instance, the U.S. has pressured European governments to relax bank secrecy rules. Gallu and Logutenkova, Switzerland, Luxembourg, Austria Loosen Secrecy Rules (Bloomberg News, March 13, 2008). In February 2009, the U.S. government sued to enforce a John Doe summons on UBS AG for the names of 52,000 Americans who allegedly hid money in Swiss accounts. UBS eventually provided a first installment of more than 300 names, the first time Swiss authorities have permitted such a disclosure since at least 1934. Id.

Likewise, with the 2005 revision of Policy Statement P-4-84 and its redesignation as Policy Statement 4-26, the IRS relaxed its own rules to permit sharing information in parallel proceedings. A comparison of the former and current policy statements illustrates how IRS procedures are changing to reflect an increased appetite for information sharing.

Policy Statement P-4-84 allowed little room for parallel investigations. Since such investigations may jeopardize both cases, it was deemed "necessary, in the overall interests of enforcement of the law, to identify those instances when criminal actions generally will take precedence over the civil aspects." See I.R.M. 1.2.1.4.25 (February 4, 1991). The procedural aspects of the policy were informed by this concern. Upon finding "affirmative indications of fraud" or "badges of fraud," a revenue agent was required to immediately cease investigating and refer the case for criminal prosecution. See I.R.M 104.2.2.1 (May 19, 1999). Simultaneous civil and criminal activity was only rarely permitted.

Policy Statement 4-26 constitutes a sea change. While it contains some of the same cautionary language as its predecessor, Policy Statement 4-26 provides greater flexibility, focused on – but not expressly limited to – abusive shelter promoters and return preparers. The new policy states "it is … necessary to identify those instances where civil and criminal actions should be
coordinated to stop abusive promoters and return preparers." The policy also contains aggressive language asserting that civil and criminal coordination is the key to preventing and stopping tax abuse. It notes, "Civil and criminal functions of the IRS should consider appropriate action against the promoter or preparer that will stop the sale of the promotion or return preparation quickly." I.R.M. 1.2.13.1.11 (October 5, 2005).

The new policy specifically delineates the review process for parallel investigations, involving review by IRS Criminal Investigation, the DOJ Tax Division and United States Attorneys Office, if one is involved in the pending or contemplated proceedings. Significantly, it does not list specific situations in which civil enforcement should be suspended pending criminal proceedings.

**E. FRE 408**

As noted above, the Federal Rules of Evidence have been amended to increase the usefulness of parallel investigations. In December 2006, the Advisory Committee on Evidence Rules put into effect amended Federal Rule of Evidence 408, which governs the admissibility of statements made during settlement discussions. Former Rule 408 provided in part: "Evidence of (1) offering or promising to furnish, or (2) accepting or offering or promising to accept, a valuable consideration in compromising or attempting to compromise a claim which was disputed as to either validity or amount, is not admissible to prove liability for or invalidity of the claim or its amount. Evidence of conduct or statements made in compromise negotiations is likewise not admissible." Fed. R. Evid. 408 (repealed, December 2006).

Amended Rule 408 is largely consistent with its predecessor. Between private parties, evidence derived from settlement discussions is still barred. But, the amended rule makes a very big exception: Rule 408 now makes admissible "conduct or statements made in compromise negotiations regarding the claim . . . related to a claim by a public office or agency in the exercise of regulatory, investigative, or enforcement authority." And, should there be any confusion as to what the rule means for parallel investigations, the Advisory Committee notes clarify: "Where an individual makes a statement in the presence of government agents, its subsequent admission in a criminal case should not be unexpected."

**F. Recent Cases**

The Supreme Court found in *United States v. Kordel*, supra, that requiring the government to pursue civil and criminal investigations separately would "stultify enforcement of federal law." 397 U.S. at 11. But, the Court did not give the government complete *carte blanche* and hinted at a specific limitation, stating, "We do not deal here with a case where the Government has brought a civil action solely to obtain evidence for its criminal prosecution or has failed to advise the defendant in its civil proceeding that it contemplates his criminal prosecution." *Id.*

In *United States v. Robson*, 477 F.2d 13 (9th Cir. 1973), the court gave the government increased flexibility, eliminating any affirmative disclosure requirement, and merely requiring the government not to lie about the existence of a parallel investigation. In *Robson*, the defendant
was being investigated for possible tax offenses. He cooperated with a civil audit, but was not
told when the investigation became focused on its criminal aspects. The court found no
constitutional violation because "[t]he IRS agent [had] not affirmatively [misled] the taxpayer
into believing that the investigation [was] exclusively civil in nature and [would] not lead to
criminal charges." Id. at 18.

Two recent cases suggested that the courts had become more willing to scrutinize the
government's conduct: United States v. Scrushy, 366 F. Supp. 2d 1134 (N.D. Ala. 2005), and

In Scrushy, the district court excluded the defendant's SEC deposition testimony from a related
criminal case because the civil case had been used covertly to gain advantages in the criminal
case. Two days before the deposition, the United States Attorney's Office had requested that it be
moved from Atlanta to Birmingham to establish venue for the eventual criminal case.
Additionally, the criminal prosecutors provided questions for SEC lawyers to ask the defendant.
Thus, the court found the two investigations to be impermissibly "commingled," and that "[b]y
definition, the separate investigations should be like the side-by-side train tracks that never
intersect." Id. at 1139. The government did not appeal.

In Stringer, a federal district court in Oregon dismissed a securities fraud and conspiracy case
upon the finding that the DOJ and SEC violated the defendant's Fifth Amendment rights. The
DOJ and SEC conducted a joint investigation into alleged revenue inflation achieved through
fraudulent accounting practices. The defendants had cooperated with the SEC investigation,
unaware that the DOJ was working closely with the SEC in procuring damning criminal
evidence.

The court found the SEC and DOJ affirmatively concealed the potential criminal prosecution,
and that while the DOJ considered a criminal indictment early on, it delayed for two years,
engaging "in deceit and trickery" to conceal its intentions. 408 F. Supp. 2d at 1089. When the
defendant's attorney specifically asked if a criminal investigation was pending, the SEC agent
referred to Form 1662, a routine SEC form that advises that information obtained in a civil
investigation may be used in a criminal prosecution. Id. at 1087. The court found that agencies'
actions were "so grossly shocking and so outrageous as to violate the universal sense of justice"
and dismissed the criminal case.

On April 4, 2008, the Ninth Circuit overturned Stringer, finding the government's use of Form
1662 to be an appropriate method of notice. The court noted that SEC Form 1662 "alerts SEC
investigative witnesses that the information can be used in a criminal proceeding" and "the
government's request for information could be refused pursuant to the Fifth Amendment's
protection against compelled self incrimination." United States v. Stringer, 535 F.3d 929, 938
(9th Cir. 2008). The Ninth Circuit found that the SEC made no "affirmative misrepresentations.
The SEC did advise defendants of the possibility of criminal prosecution. The SEC engaged in
no tricks to deceive defendants into believing that the investigation was exclusively civil in
nature." Id. at 940.
As described by the district courts, the facts in *Stringer* and *Scrushy* are similar but the eventual outcomes are not. In both cases, the DOJ was found to have hidden its interest in the SEC investigation and manipulated the situation to gain advantages in the criminal case. In neither case were the defendants told about the DOJ's involvement and potential charges. But, while both district courts dismissed the cases for those reasons, the Ninth Circuit found in *Stringer* that the government is "free" to choose "not to conduct the criminal investigation openly." *Id.* 932.

**G. Investor Protection Act of 2009**

Federal Rule of Civil Procedure 6(e) requires that grand jury material be kept confidential. This restriction extended to parallel investigations, except in relatively limited circumstances. *See United States v. Sells Engineering, Inc.*, 463 U.S. 418 (1983) (disclosure upon a showing of "particularized need"). The release to the IRS of grand jury information for use in civil tax proceedings is not permitted as preliminary to or in connection with a judicial proceeding, which is another exception to grand jury secrecy rules. *United States v. Baggot*, 463 U.S. 476 (1983) (interpreting Fed. R. Crim. P. 6(e)(3)(E)(i)).

However, in December 2009, consistent with the broader trend, the House of Representatives passed HR 4173, the Investor Protection Act of 2009, which would grant the SEC access to grand jury material and specifically anticipates parallel investigations. HR 4173, Section 7214. The provision is but one paragraph in a 1280 page bill, but may fundamentally affect how parallel investigations are conducted. Until now, civil proceedings were most often stalking horses for criminal investigations, *i.e.*, information sharing was a one-way street. The new bill envisions a relationship in which information sharing would go both ways. Query whether this portends similar changes in other areas, as well.

**H. Conclusion**

While parallel proceedings present hazards for both the government and defendants, coordination is nonetheless increasing amongst government agencies. From case law to Congress, the trend is toward increased information sharing, and defendants must be forewarned lest cooperation in civil proceedings ease the government's burden in criminal ones.