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Expert Analysis

Theft of Honest Services: Reining In a Catch-All Conflicts Statute

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No criminal statute has been more popular with prosecutors and more controversial with the courts in recent years than the federal "theft of honest services" statute, 18 U.S.C. § 1346. Prosecutors love the honest-services statute for the same reasons many courts hate it: It is short, vague and capable of seemingly endless elasticity.

Everyone gets the statute's core application: A public employee takes official action based on a concealed bribe or conflict of interest and thus deprives the electorate of the right to honest government, often without causing provable tangible harm (the charges against former Illinois Gov. Rod Blagojevich being just the most recent example).[1]

But aggressive federal prosecutors have applied the statute in a broad array of circumstances in both the private and public spheres, where they see dishonesty or a conflict of interest but cannot prove victim harm.

Prosecutors now turn to honest-services fraud early and often. In recent examples, the 7th U.S. Circuit Court of Appeals reversed the conviction of a Wisconsin state employee for her role in the award of a public travel-services contract to the low bidder (consistent with the applicable rules) where the only plausible benefit to her was her later receipt of a $1,000 raise.[2]

The 5th Circuit recently affirmed the conviction of former Enron CEO Jeffrey Skilling for theft of honest services, among other charges, in a case in which traditional concepts of mail, wire and securities fraud already offered ample prosecutorial firepower.[3] Prosecutors in Los Angeles reportedly are weighing theft of honest services as a charge enabling them to climb the chain of the Catholic Church hierarchy in the clergy sex abuse scandals (on the theory that senior officials reassigned priests while concealing from parishioners the reasons for the reassignments).[4]

Unhappy with the doctrine's breadth and malleability, federal courts have repeatedly called for Congress to rewrite it. In 2002 a 2nd Circuit panel declared it unconstitutionally vague in a case involving a public contractor

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who allegedly falsified public bidding information (although the full 2nd Circuit reversed the ruling the following year). In February Justice Antonin Scalia unsuccessfully argued for *certiorari* review to take on the statute's meaning and constitutionality in *Sorich v. United States*: "Without some coherent, limiting principle to define what 'the intangible right of honest services' is, whence it derives and how it is violated, this expansive phrase invites abuse by headline-grabbing prosecutors in pursuit of local officials, state legislators and corporate CEOs who engage in any manner of unappealing or ethically questionable conduct."[5]

Most circuit courts have been more restrained in light of their obligation to avoid reaching constitutional issues where possible. The result has been an unusual patchwork quilt of limiting principles designed to limit the statute's reach to conduct that rises to accepted definitions of what constitutes a "scheme or artifice" to defraud. Lawyers dealing with public corruption and economic crimes thus should be aware of the contours of the doctrine as it has taken shape in the various federal circuits.

A Short History of Theft of Honest Services

The doctrine of honest-services fraud reaches back to the early 1900s, when Congress amended the federal mail and wire fraud statutes, 18 U.S.C. §§ 1341 and 1343, by adding after the initial phrase "Whoever, having devised or intending to devise any scheme or artifice to defraud," the additional phrase "*or* for obtaining money or property by means of false or fraudulent pretenses, representations or promises."[6] As early as the 1940s federal courts began to read these disjunctive provisions as reflecting congressional intent to criminalize not merely schemes to swindle money or other tangible property, but also deception to deprive a victim of *intangible* rights, such as the right of citizens to have public officials perform their duties honestly. In the 1970s and 1980s prosecutors increasingly used the honest-services theory under the mail and wire fraud statutes to prosecute public officials. The theory stems from the fiduciary duty public officials owe to citizens to provide honest services to the public. Any fraud an official perpetrated for personal gain is a breach of fiduciary duty, which causes an intangible harm to the citizens, even in the absence of tangible harm.

In 1987 the U.S. Supreme Court, in *McNally v. United States,* struck down the honest-services theory, ruling that it was an impermissible interpretation of the mail and wire fraud statutes. In *McNally* the court overturned the conviction of a Kentucky public official, holding that the scope of the mail fraud statute was limited to the protection of *property rights* only, not to honest services. "'To defraud' commonly refer[s] 'to wronging one in his property rights by dishonest methods or schemes' and 'usually signif[ies] the deprivation of *something of value* by trick, deceit, chicane or overreaching.'" The court acted to avoid "constru[ing] the statute in a manner that leaves its outer boundaries ambiguous and involves the federal government in setting standards of disclosure and good government for local and state officials."[7]

Prosecutors turn to honest-services fraud early and often.

Congress responded the next year, effectively reversing *McNally* in November 1988 by enacting Section 1346.[8] The statute, captioned "definition of scheme or artifice to defraud," states in its entirety: "For the purposes 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." Neither the 28-word provision nor the legislative history sheds light on what "the intangible right of honest services" means or to whom it is owed. The circuit courts have thus struggled ever since to provide meaningful definition to the honest-services theory.

Judicial Efforts to Rein in the Statute's Scope

So What Is a Theft of Honest Services?

The paradigm of the honest-services fraud is bribery or conflict of interest involving a public official affecting his or her official duties. But since *McNally*, prosecutors increasingly have turned the statute on private actors.[9] Like the public-sector cases, the private-sector cases generally fall into two categories: bribery or kickback cases, in which someone seeking to do business with the victim entity secretly pays a bribe to the victim's employee, and self-dealing cases, in which the defendant causes his employer to do business with an entity in which the employee has a concealed financial interest.[10] In each category, the conduct at issue meets the elements of the federal mail and wire fraud statutes but does not necessarily cause the victim any financial or other property harm.

But as court after court has noted, once the element of victim harm is eliminated, the statute's potential breadth is breathtaking. Is every unethical act by a state or local public official in his or her official role a theft of honest services? What if she received a benefit with no showing that the benefit corrupted her official conduct? Conversely, what if the official engaged in favoritism, perhaps for the benefit of a politically connected constituent but received no personal benefit in return? In the private sector, is every deception of an employer or contracting party potentially a federal offense? What about the employee who misuses company letterhead for personal benefit or who calls in sick to go to a baseball game?[11]

In order to stake out meaningful boundaries around the statute's perimeters, the courts have spent two decades placing prudential limits on its application.

The various circuit courts have imposed a number of limitations designed to curtail the reach of Section 1346 as to conduct affecting public officials.

Public Official Must Violate State Law

The 3rd and 5th Circuits have required the government to prove that a public official violated an independent state law to support an honest-services-fraud conviction.[12] In *United States v. Brumley* the *en banc* 5th Circuit held that state law must provide the specific honest services owed by the defendant in a fiduciary relationship. Looking at the plain language of the statute, the court held that "[u]nder the most natural reading of the statute, a federal prosecutor must prove that conduct of a state official breached a duty respecting the provision of services owed to the official's employer under state law."[13]

But this "state law limiting principle" is a minority view. For example, the 9th Circuit reasoned last year in *United States v. Weyhrauch* that the statute, legislative history and pre-*McNally* decisions do not suggest that federal fraud statutes derive their content solely from state law. Laws governing official conduct vary state to state, and "Congress has given no indication it intended the criminality of official conduct under federal law to depend on geography." The 1st, 4th, 7th and 11th Circuits all have declined to adopt the limitation in recent decisions.[14]

Proof of a *Quid Pro Quo* in Bribery Cases

Where the government charges an official with receiving a bribe, some circuit courts limit honest-services fraud by requiring that the government prove a quid pro quo — a link between the corrupting payment and an intent to influence the official's conduct.

Earlier this year, in *United States v. Kincaid-Chauncey,* the 9th Circuit reasoned that this requirement is necessary to distinguish between an official receiving an item of value in the course of legitimate lobbying activity and a corrupt official selling his vote.[15] The 3rd Circuit also adopted this limitation in a 2007 decision, since "[t]he key to whether a gift constitutes a bribe is whether the parties intended for the benefit to be made in exchange for some official action."

Federal courts have repeatedly called for Congress to rewrite the honest-services statute.

But other courts have disagreed. For example, the 1st Circuit has reasoned that a person can be liable for honest-services fraud for giving an unlawful gratuity in exchange for an expectation of long-term favorable treatment and thus has not required proof of a specific quid pro quo.[16]

Requiring Proof of Personal Gain

The 7th Circuit further requires the government prove that the conduct was motivated by private gain: "Given the amorphous and open-ended nature of Section 1346 … courts have felt the need to find limiting principles, and ours has been that the '[m]isuse of office (more broadly, misuse of position) *for private gain* is the line that separates run-of-the-mill violations of state law fiduciary duty … from federal crime."[17]

As the court noted last year in *United States v. Sorich*, the gain need not have been the defendant's: "The true purpose of the private gain requirement — and one that does not depend on who gets the spoils — is to prevent the conviction of individuals who have breached a fiduciary duty to an employer or the public but have not done so for illegitimate gain." Thus, the 7th Circuit has upheld convictions where the defendants have misused their offices for the benefit of others. In *Sorich*, for example, the defendants' provision of public jobs to campaign workers sufficed even though they themselves received no direct benefit.

Heightened Specific-Intent Request

At least three appeals courts — the 1st, 9th and 10th Circuits — have also sought to limit the reach of Section 1346 by sharpening the specific-intent requirement.[18] As the 9th Circuit recently ruled in *Kincaid-Chauncey*, the government must prove "specific intent to defraud" the public.[19] The court agreed with the 10th Circuit that the intent that must be proven is the intent to deprive the public of honest services: "The intent to defraud does not depend upon the intent to gain, but rather on the intent to deprive."

These courts have noted that requiring proof of an intent to deprive the public of honest services (and not just personal gain) is a sufficient demarcation separating ordinary lobbying and political horse-trading on the one hand from fraudulent conduct on the other.

In short, the purpose of these limitations is to limit federal prosecutors' power to criminalize under the statute every ethical lapse by state and local officials. The courts have noted that these limitations, in various ways, aim to provide fair notice to officials of the meaning of the offense, prevent selective and potentially partisan prosecution of public officials, and safeguard against undue federal intrusions on state and local ethical matters.

As the 6th Circuit has noted, application of the "honest services" concept fits far less neatly in the private realm: "Enforcement of an intangible right to honest services in the private sector … has a much weaker justification because relationships in the private sector generally rest upon concerns and expectations less ethereal and more economic than the abstract satisfaction of receiving 'honest services' for their own sake."[20] Unlike public officials, private individuals do not typically owe one another a clear duty to provide honest services. Rather, private actors typically can at most expect good faith and fair dealing. Thus, courts have struggled with the literal breadth of the statute as applied to private actors.

Fiduciary Duty Owed by Private Actor

Analogizing to the public official context, the 2nd, 5th and 6th Circuits have held that the defendant must have owed a fiduciary duty or similar duty of loyalty to the victim for the conduct to fall within the statute's reach.[21] Such a duty is frequently found in the context of the employer-employee relationship. The 2nd Circuit, in its 2003 *en banc* ruling in *United States v. Rybicki*, invoked this principle in reversing an earlier panel's ruling in *United States v. Handakas* that the statute was unconstitutionally vague as applied. The *Rybicki* court ruled that there was no duty of loyalty owed between the contracting parties in *Handakas* and that the conduct thus fell outside the statute's prohibition and the constitutional issue should not have been addressed. But at least one circuit court has expressly rejected this "duty" requirement.[22]

'Materiality' of the Misrepresentation or Omission

The federal courts also have held that the concept of fraud imposes other limitations on the reach of Section 1346 to eliminate the risk that immaterial ethical lapses (including the extreme example of the afternoon at the ballgame) might be prosecuted. A number of courts have explained that a private employee's breach of loyalty, by itself, is insufficient to constitute honest-services fraud as the breach of loyalty must have actually mattered and conflicted with the purpose of the parties' relationship.[23] The circuit courts have taken two approaches to the problem.

Four circuit courts have held that the misrepresentation or omission must have been material, *i.e.*, such as to "naturally tend to lead or [be] capable of leading a reasonable employer to change its conduct."[24] For example, in *United States v. Jain* the 8th Circuit reversed the mail fraud conviction of a psychologist who accepted payments from a psychiatric hospital for referring patients to the hospital. It found that the defendant lacked any intent to defraud his clients. To the contrary, all the evidence suggested that the defendant intended to and did provide his patients with high-quality service. The court found no evidence that patients would have found the disclosure of the referral fees material: "When there is not tangible harm to the victim of a private scheme, it is hard to discern what intangible 'rights' have been violated."[25]

'Reasonable Foreseeability' of Employer Economic Harm

Five other circuit courts (the 1st, 4th, 6th, 11th and the District of Columbia) have addressed this question of whether the deception mattered by looking to the "reasonable foreseeability" of employer harm.[26] For example, *United States v. Frost* involved university professors who assisted graduate students who also were government employees to submit plagiarized dissertations to obtain graduate degrees. In return the

students used their government positions to help secure lucrative government contracts for a private research firm run by the defendant professors. The court held that the "prosecution must prove … that the defendant intended to breach his fiduciary duty and reasonably should have foreseen that the breach would create an identifiable economic risk to the victim." It found that the prosecution had met its burden since "the university would suffer a concrete business harm by unwittingly conferring an undeserved advanced degree" on each student defendant."[27]

"Reasonable foreseeability" does not require that the government prove *actual* economic harm to the employer. Rather, different circuit courts have held that the employee must either *anticipate* economic harm to the employer or *intend* to cause such actual financial or economic harm.[28]

Employer's Incenting, Direction of Employee Conduct

Finally, the 5th Circuit, in a line of cases in recent years, has sought to further curb the doctrine in the private sphere where there were identifiable reasons to believe defendants were acting in good faith — specifically, where they appeared to have been responding to direction by management and incentives established by an employer.

> *The circuit courts have created an unusual patchwork quilt of limiting principles.*

In the 2006 case *United States v. Brown*, the 5th Circuit vacated the convictions of Merrill Lynch employees who helped Enron "sell" assets to Merrill Lynch in order to help Enron meet revenue and earnings targets.[29] The government charged that the sale of assets was in substance a loan: Enron promised Merrill Lynch a flat fee, guaranteed an annual rate of return and promised that Enron would buy back Merrill Lynch's interest if it could not find a third-party buyer.

The 5th Circuit reversed the defendants' convictions for honest-services fraud for their participation in the transactions. It held that the defendants, who received bonuses for their efforts, could not, under the circumstances, be found to have engaged in fraud where Merrill Lynch had "intentionally align[ed] the interests of the employee with a specified corporate goal where the employee perceives his pursuit of that goal as mutually benefitting him and his employer" and where the employee conducted himself accordingly. "[S]uch conduct is beyond the reach of the honest-services theory of fraud." It distinguished an earlier 5th Circuit case, *United States v. Gray,* in which it affirmed the convictions of two Baylor University basketball coaches for helping basketball recruits violate National Collegiate Athletic Association rules to obtain necessary credits and scholarships. The court noted that even though the *Gray* defendants argued that their scheme was meant to help the university, the case was fundamentally different from *Brown* because senior university officials had no knowledge of the scheme.[30]

Under the same reasoning, in January the 5th Circuit affirmed former Enron exec Jeffrey Skilling's conviction under the honest-services-fraud theory.[31] Critically, unlike the circumstances involving the mid-level Enron employees in *Brown*, no one senior to Skilling at Enron sanctioned his conduct. The court held that even if the Enron board of directors knew of Skilling's actions, its knowledge was insufficient as there was no evidence that it had directed the activity found to have been fraudulent.

Conclusion: Navigating the Honest-Services Minefield

The amorphous quality of Section 1346 has led the federal courts to adopt a series of seemingly ad hoc and at times inconsistent, limiting rules. As evidenced by the 5th Circuit's recent opinions, the circuit courts have sought to find rules that restrict the statute's application to circumstances where they find evidence not just of dishonesty, but of specific fraudulent intent. In the right case the statute may still be vulnerable to constitutional attack for the reasons raised most recently in Justice Scalia's Sorich dissent. But, in the meantime, the array of limiting principles developed by the courts provides defense lawyers with significant bases for reining in the statute's outer reaches.

Notes

1. Superseding Indictment, *United States v. Blagojevich,* No. 08 CR 888 (N.D. Ill. Apr. 2, 2009).
2. *United States v. Thompson,* 484 F.3d 877, 884 (7th Cir. 2007).
3. *United States v. Skilling,* No. 06-20885, 2009 WL 22879, at *9-13 (5th Cir. Jan. 6, 2009).
4. Dan Slater, *From Coaches to Church Officials, An Honesty Law Gets a Workout,* Wall St. J., Feb. 5, 2009, at A14.

[5] *Sorich v. United States,* 555 U.S. ___, 2009 WL 425807, at *2 (2009) (Scalia, J., dissenting from denial of *certiorari*).

[6] Act of March 4, 1909, ch. 321, § 215, 35 Stat. 1088, 1130; *see also McNally v. United States,* 483 U.S. 350, 357-58 (1987).

[7] *See McNally,* 483 U.S. at 358.

[8] The courts have generally agreed in substance that Section 1346 restored pre-*McNally* case law as guiding the contours of the offense. *See, e.g., United States v. Frost,* 125 F.3d 346, 368 (6th Cir. 1997) ("We therefore hold that Section 1346 has restored the mail-fraud statute to its pre-*McNally* scope, according to previous opinions interpreting the intangible right to honest services."); *see also United States v. Rybicki,* 354 F.3d 124, 145 (2d Cir. 2003) (*en banc*); *United States v. Brumley,* 116 F.3d 728, 733 (5th Cir. 1997).

[9] *See, e.g., Soricn,* 2009 WL 425807, at *1 (citing cases in which courts upheld convictions of private individuals for honest-services fraud). *See also United States v. Weyhrauch,* 548 F.3d 1237, 1247 (9th Cir. 2008); *United States v. deVegter,* 198 F.3d 1324, 1327-28 (11th Cir. 2000) (the "paradigm" case of honest-services fraud is bribery of a public official).

[10] *Rybicki*, 354 F.3d at 138-42 (collecting cases in each category).

[11] *See Sorich,* 2009 WL 425807, at *1.

[12] *United States v. Panarella,* 277 F.3d 678, 692-93 (3d Cir. 2002); *Brumley*, 116 F.3d at 734-35.

[13] *Brumley*, 116 F.3d at 734.

[14] *Weyhrauch*, 548 F.3d at 1245-47; *United States v. Sorich,* 523 F.3d 702, 712 (7th Cir. 2008); *United States v. Urciuoli,* 513 F.3d 290, 298-99 (1st Cir. 2008); *United States v. Walker,* 490 F.3d 1282, 1299 (11th Cir. 2007); *United States v. Bryan,* 58 F.3d 933, 942 (4th Cir. 1995), *abrogated on other ground by United States v. O'Hagan,* 521 U.S. 642 (1997).

[15] *United States v. Kincaid-Chauncey,* 556 F.3d 923, 943 (9th Cir. 2009).

[16] *United States v. Kemp,* 500 F.3d 257, 282 (3d Cir. 2007); *United States v. Sawyer,* 85 F.3d 713, 730 (1st Cir. 2001).

[17] *Sorich*, 523 F.3d at 707 (quoting *United States v. Bloom*, 149 F.3d 649, 655 [7th Cir. 1998]). The 7th Circuit also applies this limitation to honest-services fraud in the private context. *See United States v. Black,* 530 F.3d 596, 600 (7th Cir. 2008).

[18] *Kincaid-Chauncey,* 556 F.3d at 941; *United States v. Welch,* 327 F.3d 1081, 1106 (10th Cir. 2003); *United States v. Sawyer (Sawyer II),* 239 F.3d 31, 41 (1st Cir. 2001).

[19] *Kincaid-Chauncey,* 556 F.3d at 941.

[20] *See Frost,* 125 F.3d at 365; *see also deVegter,* 198 F.3d at 1328 ("Most private sector interactions do not involve duties of, or right to, the 'honest services' of either party.").

[21] *See, e.g., Skilling,* 2009 WL 22879, at *13; *Rybicki*, 354 F.3d 124; *Frost*, 125 F.3d at 366 (the defendant college professors owed fiduciary duties to the university because of their influence over whether the university would give a degree to a student). In *Rybicki*, four 2nd Circuit judges dissented from the majority ruling, maintaining that the statute was unconstitutional.

[22] *See United States v. Ervasti,* 201 F.3d 1029, 1036 (8th Cir. 2000)

[23] *See, e.g., deVegter,* 198 F.3d at 1328.

[24] *Rybicki*, 354 F.3d at 145; *United States v. Cochran,* 109 F.3d 600, 667 (10th Cir. 1997); *United States v. Gray,* 96 F.3d 769, 774-75 (5th Cir. 1996); *United States v. Jain,* 93 F.3d 436, 442 (8th Cir. 1996).

[25] *Jain*, 93 F.3d at 442. Because the patients were not actually harmed by the defendant's unethical receipt of referral fees, the court required the government to prove the defendant's intent to defraud patients, separate and apart from his receipt of payments. The court found no such evidence of intent. *Id.* Similarly, in *Cochran*, the 10th Circuit held that "Section 1346 must be read against a backdrop of the mail and wire-fraud statutes, thereby requiring fraudulent intent and a showing of materiality." 109 F.3d at 667. The *Cochran* court reversed the defendant's wire-fraud conviction, finding no evidence that the defendant's failure to disclose a payment from a third party was material. *Id.* at 669.

[26] *United States v. Vinyard,* 266 F.3d 320, 328-29 (4th Cir. 2001); *United States v. Martin,* 228 F.3d 1, 17 (1st Cir. 2000); *deVegter*, 198 F.3d at 1328-30; *United States v. Sun-Diamond Growers of Cal.,* 138 F.3d 961, 973-74 (D.C. Cir. 1998); *Frost*, 125 F.3d at 368.

[27] *Frost*, 125 F.3d at 369. The court noted that in the absence of its requirements of proof of breach of fiduciary duty and anticipated financial harm to the employer, the statute impermissibly would criminalize all dishonest employee conduct utilizing interstate mails or wires. *Id.* at 368.

[28] Compare *Vinyard*, 266 F.3d at 329 (employee must anticipate economic harm), with *United States v. Pennington,* 168 F.3d 1060, 1065 (8th Cir. 1999) (employee must cause or intend to cause actual financial or economic harm).

[29] *United States v. Brown,* 459 F.3d 509, 513, 517 (5th Cir. 2006).

[30] *Id.* at 522-23; *Gray*, 96 F.3d 769.

[31] *Skilling*, 2009 WL 22879, at *13. The government's theory allowed for three potential objects of conspiracy: securities fraud, wire fraud to deprive Enron and its shareholders of money and property, or wire fraud to deprive Enron and its shareholders of honest services owed by its employees. Although the jury convicted Skilling of conspiracy it returned a general verdict that did not specify which of the government's theories it relied upon. On appeal the 5th Circuit held that honest-services fraud, as used against Skilling, was a valid theory.

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