

Jeff Skilling's Constitutional Challenge To "Theft of Honest Services"

By David R. McAtee II and Jason E. Wright



Daniel Petrocelli, right, attorney for former Enron CEO Jeffrey Skilling, outside the U.S. Supreme Court after arguing his appeal. (AP Photo/Manuel Balce Ceneta)

The title of a recent book claims that the average American unknowingly commits three felonies a day due to vague federal laws.¹ If this claim is true — and for the record, the authors deny committing any crimes today — then it must rest in part on the felony known as “theft of honest services,” codified at 18 USC §1346 and criticized by some as broad enough to criminalize just about any malfeasance by a fiduciary. In *Skilling v. United States*, however, the U.S. Supreme Court recently considered whether §1346 is unconstitutionally vague and held that, when limited to schemes involving bribes and kickbacks, it is not.² As a result, it appears that “theft of honest services” will continue to play a significant, if more limited, role in the prosecution of corporate crime, and *Skilling* will be required reading for those who deal with such claims.³

What Is “Theft of Honest Services”?

“Theft of honest services” under 18 USC §1346, also known as “honest-services fraud,” is a subset of mail and wire fraud under 18 USC §§1341 and 1343.⁴ Enacted in 1872, the first mail fraud statute prohibited the use of the mails in furtherance of “any scheme or artifice to defraud.”⁵ In 1909, however, Congress amended the statute to read “any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses.”⁶ While this amendment clarified

that the statute proscribed future schemes to defraud, the disjunctive “or” suggested that a scheme need not result in the loss of money or property to be criminal, prompting some to argue the statute was thenceforth broad enough to encompass a deprivation of “intangible rights.”⁷

In the 1970s, the U.S. Department of Justice began using the intangible-rights theory to indict public officials for depriving citizens of their right to “good government.”⁸ Because there were no express federal laws prohibiting state or local officials from receiving bribes or kickbacks, the mail and wire fraud statutes were often the only way for federal prosecutors to address government corruption at the local level.⁹ Traditional “money-or-property” fraud was not always useful because the tangible thing (money or property) obtained by a dishonest official was willingly provided by a third party (the briber) rather than stolen from a defrauded victim. With honest-services fraud, prosecutors were able to allege that the victim (the citizenry) was deprived of something other than money or property.¹⁰ Over time, prosecutors began to assert, and courts began to accept, honest-services claims in the private sector based not only on bribes and kickbacks, but on a range of conduct inconsistent with a defendant’s fiduciary obligations.¹¹ By 1982, all courts of appeals had embraced the notion of honest-services fraud.¹² All of that stopped, however, in 1987.

The Origins of 18 USC §1346

In 1987, the U.S. Supreme Court struck down the theory of honest-services fraud in *McNally v. United States*.¹³ In *McNally*, three individuals were convicted of a kickback scheme involving a contract for Kentucky's state insurance policies. In a 7-2 decision, the Court rejected the idea that the 1909 amendment created the offense of honest-services fraud separate from traditional money-or-property fraud. The Court acknowledged the mail and wire fraud statutes were ambiguous, but held that they required a loss of money or property to the defrauded victim. In so ruling, the Court stated "if Congress desires to go further, it must speak more clearly than it has."¹⁴

Within a year, Congress spoke by enacting 18 USC §1346, which 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.

In 28 words, this provision overturned *McNally* and explicitly expanded the reach of the mail and wire fraud statutes to include the theft of honest services. It did not, however, define honest services or establish any limits as to the conduct it covered.¹⁵ Furthermore, because §1346 was a last-minute addition to a larger drug bill, there was virtually no legislative history to clarify Congress' intent.¹⁶

Once enacted, §1346 was used to prosecute an increasing range of conduct. Public officials were indicted for not disclosing actual or potential conflicts of interest, even if they received no financial benefit or there was no clear duty to disclose. For example, Chicago city officials were convicted for handing out jobs to politically favored individuals even though the defendants received nothing in return and the city still received competent workers.¹⁷ Similarly, in the private sector, fiduciaries faced the threat of prosecution when they acted in a manner inconsistent with the interests of their employer. Notable in Texas, three Baylor basketball coaches were convicted of honest services fraud for helping prospective transfer students cheat on their exams in violation of NCAA rules.¹⁸ In the wake of Enron's collapse in 2001, and again in a series of high-profile stock option "backdating" indictments beginning in 2006, theft of honest services gained notoriety as a favored charge in the prosecution of corporate fraud. In 2010, *Fortune* called honest-services fraud "the catchall fraud law that catches too much."¹⁹

Skilling v. United States

In the years following the enactment of §1346, the crime of honest-services fraud continued to evolve among the circuit courts, often with disparate standards. In some circuits, §1346 itself (or an indistinct notion of an "inherent" duty of honest services) provided the source of the breach;²⁰ whereas other circuits required a violation of state or federal law.²¹ Circuits also took different views as to whether there must be harm to the

victim²² or, inversely, some gain to the defendant before there could be a deprivation of honest services.²³ Other circuits focused on whether the misrepresentation or omission was "material" in that it would lead a reasonable employer to act differently.²⁴

Throughout this period, the Supreme Court repeatedly declined to address the limits of honest-services fraud. In a dissent to a 2009 denial of certiorari, Justice Antonin Scalia expressed his own frustration when he wrote that §1346 "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."²⁵ Within eight months, the Court accepted three cases raising questions about the scope and constitutionality of §1346: *Black v. United States*,²⁶ *Weybrauch v. United States*,²⁷ and *Skilling v. United States*.²⁸ Of the three, *Skilling* was the only case in which the constitutionality of §1346 was at issue.

The facts surrounding the collapse of Enron are well-known. In *Skilling*, however, the government did not contend that Skilling acted with an intention to harm Enron or its shareholders. Rather, the government alleged only that fraudulent accounting practices were employed for the purpose of increasing Enron's share price and, ultimately, Skilling's compensation.²⁹ At trial, Skilling was convicted of honest-services fraud (among 18 other charges) and was sentenced to 292 months' imprisonment, three years' supervised release, and \$45 million in restitution.³⁰ The 5th Circuit affirmed the conviction, holding that §1346 requires only a material breach of a fiduciary duty that results in a detriment to the employer.³¹ The Supreme Court granted certiorari to determine whether §1346 requires a showing of private gain to the defendant that is inconsistent with the employer's interests.³²

In *Skilling*, Justice Ruth Bader Ginsberg delivered the unanimous opinion of the Court. After reviewing the history of honest-services fraud, the Court concluded that "[i]n the main, the pre-*McNally* cases involved fraudulent schemes to deprive another of honest services through bribes or kickbacks supplied by a third party who had not been deceived."³³ With that background, the Court reasoned that, when Congress enacted §1346 in response to *McNally*, it intended to reach "at least" bribes and kickbacks.³⁴ Therefore, rather than strike down §1346 as unconstitutionally vague, the Court elected to construe it in a fashion consistent with Congress's intent. Limited to schemes involving bribes and kickbacks, the Court held, the statute is not unconstitutionally vague.³⁵ As Justice Ginsberg wrote: "Reading §1346 to proscribe bribes and kickbacks — and nothing more — satisfies Congress' undoubted aim to reverse *McNally* on its facts."³⁶ In so holding, the Court rejected the government's argument that §1346 should also encompass undisclosed self-dealing by a public official or private employee.³⁷

Because the Government did not allege that Skilling's fraud included side payments from a third party, the Court ruled that, under its construction of §1346, "Skilling did not com-

mit honest-services fraud."³⁸ The Court therefore vacated the 5th Circuit's ruling on that conviction and remanded the case for further proceedings. Interestingly, Justices Scalia, Clarence Thomas, and Anthony Kennedy concurred in the judgment, but argued that §1346's constitutional problems could not be corrected with a limiting construction and that the entire statute should be declared unconstitutional.³⁹

The Impact of *Skilling*

When it was issued in June, the Supreme Court's decision in *Skilling* was front-page news across the country. Today, it continues to be newsworthy as high-profile petitioners are released on bail, and several commentators have already questioned what the future holds for fraud prosecutions in light of *Skilling*. At the outset, however, it is important to remember what *Skilling* does *not* affect. As interesting as it is, the decision is irrelevant to allegations that a defendant engaged in traditional "money-or-property" mail or wire fraud. Schemes to obtain money or property through false pretenses will still be prosecuted as mail and wire fraud, and as practitioners in this area are already well-aware, those statutes are powerful weapons in cases where the victim has suffered direct harm. As one prosecutor vividly stated:

To federal prosecutors of white collar crime, the mail fraud statute is our Stradivarius, our Colt 45, our Louisville Slugger, our Cuisinart — and our true love. We may flirt with RICO, show off with 10b-5, and call the conspiracy law "darling," but we always come home to the virtues of 18 USC §1341, with its simplicity, adaptability, and comfortable familiarity.⁴⁰

Beyond the confines of traditional mail and wire fraud, *Skilling* will certainly affect honest-services cases predicated only on an undisclosed conflict of interest that did not cause the victim to lose money or property. Pending charges will be dropped,⁴¹ those serving sentences will get review,⁴² and even those who have completed a sentence may get relief.⁴³ In reality, though, much of the criticism of §1346 prior to *Skilling* was focused on the law's potential application to everyday low-level employees rather than on its particular application to high-level officials such as Jeff Skilling. In oral arguments for *Skilling*, *Black*, and *Weyhrauch*, several Justices expressed this concern by asking hypothetical questions in which ordinary workers could be prosecuted under the statute for relatively innocuous acts. One example often cited was the worker who calls in sick in order to catch a game at the ballpark.⁴⁴ Before *Skilling*, the only thing that theoretically stood between a healthy worker in the upper deck and jail time was prosecutorial discretion. Now it is clear that such minor ethical violations cannot be prosecuted under §1346.

With theft of honest services limited to schemes involving bribes or kickbacks, perhaps the average American will sleep better knowing that their number of daily felonies has dropped

from three to two. Congress, however, always has the option of speaking more clearly (again) in an amendment to §1346. Indeed, some states are already taking up this challenge by considering laws that would expand the reach of honest-services fraud beyond bribes and kickbacks.⁴⁵ In any case, the federal prosecutor's trusty "Louisville Slugger" of traditional mail and wire fraud still has plenty of heft to address most serious ethical breaches; and if those breaches involve bribes or kickbacks, the indictment will almost certainly include theft of honest services as well.

Notes

1. See *Harvey A. Silvergate, Three Felonies a Day: How the Feds Target the Innocent* (2009).
2. No. 08-1394, slip op., 561 U.S. ____ (June 24, 2010).
3. Which includes the authors, who wish to disclose that they handle matters in which the application of 18 USC §1346 is at issue.
4. See *id.* at *3 n.1; *United States v. Redzic*, 569 F.3d 841, 845 (8th Cir. 2009) ("Section 1346 does not create a separate offense but expands the definition of scheme or artifice to defraud for both mail and wire fraud.").
5. Act of June 8, 1872, ch. 335, §301, 17 Stat. 283, 323.
6. Act of Mar. 4, 1909, ch. 321, §215, 35 Stat. 1088, 1130 (emphasis added).
7. See *Skilling*, No. 08-1394, slip op. at *35. The first use of the "intangible rights" theory is credited to *Shushan v. United States*, 117 F.2d 110 (1941) ("A scheme to get a public contract on more favorable terms than would likely be got otherwise by bribing a public official would not only be a plan to commit the crime of bribery, but would also be a scheme to defraud the public.").
8. See *McNally v. United States*, 483 U.S. 350, 356 (1987).
9. 18 USC §666 was not enacted until 1984.
10. See *Skilling*, No. 08-1394, slip op. at *35-36.
11. *Id.* at *36; *3-7 (Scalia, J., concurring).
12. *Id.* at *37.
13. 483 U.S. 350 (1987).
14. *Id.* at 360.
15. Justice Scalia noted *McNally* did not even consistently define the theory of fraud it rejected. *Skilling*, No. 08-1394, slip op., at *3 (Scalia, J., concurring).
16. See *United States v. Brumley*, 116 F.3d 728, 739 (5th Cir. 1997).
17. *United States v. Sorch*, 523 F.3d 702, 709-11 (7th Cir. 2008) (finding that gain appreciated by any individual — even an individual unaware of the fraud — suffices for the private gain limiting principle).
18. *United States v. Gray*, 96 F.3d 769 (5th Cir. 1996).
19. Roger Parloff, *The Catchall Fraud Law That Catches Too Much*, *Fortune*, Jan. 6, 2010, available at http://money.cnn.com/2010/01/04/magazines/fortune/fraud_law.fortune/index.htm.
20. See, e.g., *United States v. Weyhrauch*, 548 F.3d 1237, 1248 (9th Cir. 2008) ("We hold that 18 USC §1346 establishes a uniform standard."); *United States v. DeVegter*, 198 F.3d 1324, 1328 (11th Cir. 1999) ("Public officials inherently owe a fiduciary duty to the public to make governmental decisions in the public's best interest.").
21. See, e.g., *United States v. Brumley*, 116 F.3d 728, 734-35 (5th Cir. 1997) (requiring violation of a state law); *United States v. Murphy*, 323 F.3d 102, 116-17 (3d Cir. 2003) (requiring violation of a state or federal law).
22. See, e.g., *United States v. Frost*, 125 F.3d 346, 368 (6th Cir. 1997) (requiring that the employee foresaw or reasonably should have foreseen that his employer might suffer an economic harm as a result of the breach).
23. See, e.g., *United States v. Black*, 530 F.3d 596, 600 (7th Cir. 2008) (finding a private gain to the defendant was all that was required); see also *United States v. Spano*, 421 F.3d 599, 603 (7th Cir. 2005) ("A participant in a scheme to defraud is guilty even if he is an altruist and all the benefits of the fraud accrue to other participants.").
24. See, e.g., *United States v. Rybicki*, 354 F.3d 124, 145 (2d Cir. 2003) (holding that "the misrepresentation or omission at issue for an 'honest services'

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- fraud conviction must be 'material,' such that the misinformation or omission would naturally tend to lead or is capable of leading a reasonable employer to change its conduct").
25. *Sorich v. United States*, No. 08-410, slip op. at *3-4, 555 U.S. ____ (Feb. 23, 2009) (Scalia, J., dissenting from denial of certiorari).
 26. No. 08-876, slip op., 561 U.S. ____ (June 24, 2010).
 27. No. 08-1196, slip op., 561 U.S. ____ (June 24, 2010).
 28. No. 08-1394, slip op., 561 U.S. ____ (June 24, 2010).
 29. Brief for Petitioner at 3-4, *Skilling v. United States*, No. 08-1394, 561 U.S. ____ (June 24, 2010).
 30. *United States v. Skilling*, 554 F.3d 529, 542 (5th Cir. 2009).
 31. *Id.* at 547.
 32. *Skilling v. United States*, No. 08-1394, slip op. at *10-11, 561 U.S. ____ (June 24, 2010).
 33. *Id.* at *39.
 34. *Id.* at *44.
 35. *Id.* at *48.
 36. *Id.* at *46.
 37. *Id.* at *46-47.
 38. *Id.* at *49-50.
 39. *Id.* at *1 (Scalia, J., concurring).
 40. Jed S. Rakoff, *The Federal Mail Fraud Statute (Part I)*, 18 *Duq. L. Rev.* 771, 771 (1980).
 41. See, e.g., Katie Durio, *United States Asks Court to Dismiss Charges in Poverty Point Reservoir Fraud Case*, KATC.COM, July 6, 2010, <http://www.katc.com/news/united-states-asks-court-to-dismiss-charges-in-poverty-point-reservoir-fraud-case/> (last visited July 8, 2010).
 42. Many lower courts in the aftermath of *McNally* agreed the ruling was entitled to retroactive application under *Davis v. United States*, 417 U.S. 333 (1974). However, this occurred prior to the Court's retooling of the retroac-

- tivity doctrine in regard to subsequent procedural changes. See *Teague v. Lane*, 489 U.S. 288 (1989). It remains to be seen how courts will characterize the retroactive effect of *Skilling*.
43. See Diane M. Duszak, Note, *Post-McNally Review of Invalid Convictions Through the Writ of Coram Nobis*, 58 *Fordham L. Rev.* 979 (1990) (discussing the availability of the writ to those whose sentences had already been served).
 44. See Transcript of Oral Argument at 36, 38-39, 41, 55, *Black v. United States*, No. 08-876, 561 U.S. ____ (June 24, 2010).
 45. Legislators in New York recently introduced a type of honest services law that would create a "duty of faithful public service," defined as "[c]onduct that is free of self-dealing and free of unlawful or unauthorized conferral or intended conferral of a benefit to a public servant." Nicholas Confessore, *State Bill to Take on Public Corruption*, *N.Y. Times*, May 3, 2010, available at <http://www.nytimes.com/2010/05/04/nyregion/04prosecute.html>.



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