Honest Services Fraud in the Private Sector

Raymond Banoun
Catherine Razzano
Rajal Patel
Lex Urban[1]
Cadwalader, Wickersham & Taft LLP
Washington, D.C.

Honest services fraud, also known as the "intangible rights" theory of mail and wire fraud, has been the subject of controversy both before and after the Supreme Court's decision in *McNally v. United States*, 483 U.S. 350 (1987). Prior to *McNally*, the mail and wire fraud statutes proscribed schemes to defraud others of tangible property or financial interests, and of the intangible right to honest services. In the 1970's and early 1980's, prosecutors regularly relied on 18 U.S.C. §§1341 and 1343 to charge public officials or private sector employees for devising such schemes to commit fraud where either the U.S. mail or interstate wires were used. The *McNally* decision ended this practice by holding that these statutory provisions were "limited in scope to the protection of property rights," and did not extend to intangible rights. *See McNally*, 483 U.S. at 360.

In 1988, Congress, sought to reverse *McNally* by enacting 18 U.S.C. §1346 which provided that, for purposes of the mail and wire fraud statutes, "the term 'scheme or artifice to defraud' includes a scheme or artifice to deprive another of the intangible right of honest services." However, neither this new provision nor the legislative history defined the phrase "intangible right of honest services," or the type of conduct that the legislature intended to prohibit, thereby creating confusion over the reach of section 1346.

As a result, section 1346 has been routinely used to prosecute a wide variety of conduct by both public officials and private individuals. The standards and requirements for such a prosecution against a public official have been better defined than those involving persons in the private sector. This is understandable as the justification for applying section 1346 to public officials is evident; a violation of honest services by a public official through corruption or self-dealing that breaches "the essence of the political contract." *See United States v. Jain*, 93 F.3d 436, 441 (8th Cir. 1996). Although Congress may have intended to apply section 1346 to the private sector, its failure to specifically state that intent has left prosecutors with the discretion and ability to criminalize conduct in private industry that may not otherwise be illegal. The courts have also been unable to enunciate clear guidelines for what constitutes "honest services fraud" in the private sector. However, the Supreme Court will have the opportunity to either determine the constitutionality of the law or to clarify its scope when it issues its rulings in *Black v. United States*, 129 S. Ct. 2379 (argued Dec. 8, 2009) (No. 08-876) and *Skilling v. United States*, 130 S. Ct. 393 (Oct. 13, 2009) (No. 08-1394).[2]

Requirements for Establishing an Honest Services Fraud Violation

Currently, the circuit courts are split regarding whether a breach of a fiduciary duty is required to convict an individual in the private sector of "honest services" fraud. However, all courts agree that some duty must be breached in order to do so.

Fiduciary Duty Required

Although the wording of section 1346 is broad and does not impose any requirement beyond engaging in a "scheme or artifice to defraud another of the intangible right of honest services," several circuit courts have held that the law requires a breach of a fiduciary duty to sustain the conviction of an individual in the private sector.[3] Thus, technically, even mere dishonesty by an employee could become a federal crime if it were deemed a breach of an existing fiduciary relationship. *See United States v. Frost*, 125 F.3d 346, 368 (6th Cir. 1997) (affirming the honest services fraud conviction of university professors for permitting students to plagiarize material and, as a result, obtain advanced degrees). Some courts, however, have instituted additional requirements to limit the application of the rule, including that either the harm caused by the conduct was actual or reasonably foreseeable, that the omission or misrepresentation involved was material, or that the conduct was neither approved, nor sanctioned, by the employer.

Actual or Reasonably Foreseeable Harm

The First and Sixth Circuits have held that it must have been reasonably foreseeable that the employer, or person to whom the fiduciary duty was owed, would suffer economic harm as a result of the employee's conduct. *See, e.g., United States v. Martin,* 228 F.3d at 17; *United States v. Frost*, 125 F.3d at 368-69.

The District of Columbia Circuit has required that the defendant reasonably foresaw that economic harm *could* have resulted from his breach of fiduciary duty. *United States v. Sun-Diamond*, 138 F.3d 961, 973 (D.C. Cir 1998). In *Sun-Diamond*, an employee convinced a partner at one of its law firms to funnel illegal contributions to a political candidate through various surreptitious means. *Id.* at 969-70. The court warned that:

> In the private sector context, § 1346 poses special risks. Every material act of dishonesty by an employee deprives the employer of that worker's 'honest services,' yet not every act is converted into a federal crime by the mere use of the mails or interstate phone system. Aware of that risk that federal criminal liability could metastasize, we held in [*United States v.*] *Lemire* that "not every breach of fiduciary duty works a criminal fraud." *Lemire,* 720 F.2d [1327,] at 1335, quoting *United States v. George*, 477 F.2d 508, 512 (7th Cir. 1973). Rather, "[t]here must be a failure to disclose something which in the knowledge or contemplation of the employee poses an independent business risk to the employer." *Id.* at 1337.

Id. at 973.

Thus, "absent reasonably foreseeable economic harm, '[p]roof that the employer simply suffered only the loss of the loyalty and fidelity of the [employee] is insufficient to convict.'" *United States v. Sun-Diamond*, 138 F.3d at 973 (citing *United States v. Frost*, 125 F.3d at 368). The court added that it is insufficient to cite the criminal law presumption that one intends the "natural and foreseeable consequences of his voluntary actions," as that argument would defeat the requirement of intent. *Id.* at 974. Nonetheless, the court found that, in that instance, it was reasonably foreseeable that if the scheme had become known, the law firm would have suffered considerable losses as a result of negative publicity and affirmed the conviction of Sun-Diamond despite the lack of actual harm. *Id.* at 974.

The Seventh Circuit, however, went further to require that the fiduciary duty be breached at the "expense of the person to whom that duty is owed." *United States v. Hausmann*, 345 F.3d 952, 956 (7th Cir. 2003). In other words, it must be established that the victim experienced some actual harm. In that case, Hausmann, a Milwaukee-based personal injury lawyer, referred clients to a chiropractor for services that were paid from insurance settlement proceeds. The chiropractor kicked back twenty percent of the fees he collected to third parties, including a marketing firm, charities, and other business entities in which Hausmann held an interest. *Id.* at 954. The court

affirmed Hausmann's conviction because he used his fiduciary relationship "for [personal] gain at the expense of the party to whom the duty was owed." *Id.* at 956. The court reasoned that, absent Hausmann's fraud, his clients could have received the value of the kickbacks as a discount and, thus, suffered economic harm, despite the fact that they were charged competitive fees by the chiropractor. *Id.* at 957.

Materiality

Some courts have also required that the misrepresentation made or the information that was withheld be material in nature. The Second Circuit found that information is material if it either led, or was capable of leading, a reasonable employer to change its conduct. *United States v. Rybicki,* 354 F.3d 124, 145 (2d Cir. 2003)(en banc).[4] This requirement is broader than the reasonably foreseeable harm test as it is not limited to economic or pecuniary damage. *Id.* at 146.

In *United States v. Gray,* 96 F.3d 769 (5th Cir. 1996), the Fifth Circuit applied this same materiality test to uphold the conviction of Baylor University basketball coaches who devised and executed a scheme to academically qualify students they recruited by providing them answers to exams. Although this conduct constituted a violation of NCAA rules, the coaches argued that they did not receive any personal gain and were only seeking to field a competitive team for the university. *Id.* at 774.

The court considered (1) whether the coaches had a duty to disclose their plan to their employer and (2) whether the information the coaches failed to disclose was material to the university's decision to admit the students. It concluded that the coaches had a duty to disclose their "cheating scheme" to the university, and that the information was material because Baylor could have recruited other eligible, qualified students. Thus, the scheme itself and the failure to disclose it were both material as Baylor University could have altered its decisions had it been aware of the coaches' actions. *Id.* at 775.

Exception Where Employer Approved or Sanctioned the Conduct

The Fifth Circuit has also required that an employer neither have approved nor sanctioned the conduct that is alleged to have violated section 1346. In *United States v. Brown,* 459 F.3d 509 (5th Cir. 2006), in order to meet corporate earnings targets, Enron employees transferred leases of Nigerian barges to Merrill Lynch with the understanding that the latter would be able to return them to Enron or transfer them to another party without suffering any adverse financial consequence. The Fifth Circuit reversed the employees' convictions, distinguishing the case from *Gray* because Enron's Chief Financial Officer had sanctioned the employees' conduct as part of a known corporate goal, whereas the basketball coaches in *Gray* had acted without the university's knowledge. The court ruled that the conduct is beyond the scope of section 1346 when (1) an employer aligns an employee's interests with a specified corporate goal, (2) the employee perceives his pursuit of that goal to benefit both himself and the company, and (3) the employee's conduct is consistent with that perception, that conduct is beyond the scope of section 1346. *Id.* at 522.

On January 6, 2009, the Fifth Circuit reiterated that standard but reached the opposite conclusion in *United States v. Skilling*, 2009 WL 22879 at *21-23, because the defendant, who had been the Chief Executive Officer of Enron and engaged in multiple fraudulent schemes to manipulate earnings to meet expected projections, had not acted "at the explicit direction of anyone and therefore he [could not] avail himself of the exception from *Brown*." *Id.* at *22. The court explained, "First, Enron created a goal of meeting certain earnings projections. Second, Enron aligned its interest with Skilling's personal interests, e.g., through his compensation structure, leading Skilling to undertake fraudulent means to achieve the goal. Third – and fatally to Skilling's argument – no one at Enron sanctioned Skilling's improper conduct." *Id.* It added that a "senior executive cannot wear his 'executive' hat to sanction a fraudulent scheme and then wear his 'employee' hat to perpetuate

that fraud." *Id.* The fact that the Board of Directors had approved a number of the fraudulent transactions was of "no moment" because there was no evidence that it had consented to the "secret side deals between Skilling and [Chief Financial Officer] Fastow." *Id.* at *22 n.13.[5]

Fiduciary Duty Not Required

Not all appellate courts, however, require the existence of a fiduciary duty to sustain a conviction for honest services fraud.[6] The Eighth Circuit held that, although a fiduciary relationship is not required, it is a factor in determining if a duty of honest services has been breached. *United States v. Ervasti*, 201 F.3d 1029, 1036 (8th Cir. 2000). In *Ervasti,* the defendants operated a payroll processing company that failed to make payments to the Internal Revenue Service on behalf of customers, instead using the funds collected for that purpose to pay their own expenses. *Id.* at 1033. Without further explanation, the court held that a breach of a fiduciary duty is "not a necessary element," because nothing in section 1346 "suggests the contrary." *Id.* at 1036.

In contrast, the Second Circuit concluded that a fiduciary relationship need not exist to affirm a conviction under the statute because the only requirement is that a person be in a relationship similar to that of an employer and employee. *United States v. Rybicki*, 354 F.3d at 142. Two personal injury lawyers had made secret payments to insurance claims adjusters in order to expedite claims. *Id.* at 127. The adjusters accepted the payments and failed to report them to their employers despite the existence of company policies that prohibited the acceptance of gratuities. *Id.* The Second Circuit affirmed the conviction of the lawyers for depriving the insurance companies of the honest services of their employees, ruling that they were "in a relationship that gives rise to a duty of loyalty comparable to that owed by employees to employers," and that an employee's failure to disclose his personal interest must have caused "or at least [been] capable of causing, some detriment to the employer." *Id.* at 141-42.

Determining a Breach of Duty

Regardless of the nature of the relationship of the parties, some duty must be breached in order to constitute honest services fraud. However, courts have struggled to determine if the breach of that duty had to be an actual violation of federal or state law, or if it even needed to amount to a violation of law at all. At least one appellate court required that a duty established under state law be breached as a prerequisite for an honest services fraud violation. Other appellate courts do not require a breach of a duty established under state law to convict under section 1346. Adding to the uncertainty, the Second and Sixth Circuits have held that pre-*McNally* decisions should be consulted as guidance in determining what Congress intended the term "honest services" to mean.[7]

In a case involving the prosecution of a Texas public official for conspiring to defraud the citizens of his honest services, the Fifth Circuit inquired whether, "services [must] be owed under state law? Second, must the breach of a duty to provide services rooted in state law violate the criminal law of the state?" *United States v. Brumley,* 116 F.3d 728, 734 (5th Cir. 1997). The court concluded, "that services must be owed under state law and that the government must prove in a federal prosecution that they were in fact not delivered." *Id.* The court elaborated that:

> We will not lightly infer that Congress intended to leave to courts and prosecutors, in the first instance, the power to define the range and quality of services a state employer may choose to demand of its employees. We find nothing to suggest that Congress was attempting in § 1346 to garner to the federal government the right to impose upon the states a federal vision of appropriate services—to establish, in other words, an ethical regime for state employees. . . . Under 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 of-

> ficial's employer under state law. Stated directly, the official must act or fail to act contrary to the requirements of his job under state law.

Id.

Brumley, a Texas Workers Compensation Commission employee who conducted pre-hearing conferences to determine the amount of submitted claims, solicited loans from lawyers who appeared before him. In return for the loans, Brumley gave preferential treatment to the lawyers, such as referrals of unrepresented claimants. *Id.* at 731. In at least one instance, Brumley advised a lawyer on how to alter documents subpoenaed by the Commission in order to assist the lawyer in evading punishment. *Id.* at 735. By accepting benefits from those who appeared before him and using his office to pursue his personal needs and not those of his employer, Brumley breached an obligation imposed by state law.[8] *Id.* at 735.

The Fifth Circuit applied the same reasoning in *Skilling* with respect to individuals in the private sector. The court required the following elements to sustain such a conviction:

> (1) a material breach of a fiduciary duty imposed under state law, including duties defined by the employer-employee relationship . . . (2) that results in a detriment to the employer. . . . Further, it is a sufficient detriment for an employee, contrary to his duty of honesty, to withhold information, i.e., information that he had reason to believe would lead a reasonable employer to change its conduct.

United States v. Skilling, 2009 WL 22879 at *23.

In *Rybicki,* the Second Circuit followed a different path.[9] It held that in order to determine the legislative intent of Congress, it needed to review cases decided pre-*McNally*.

> Our task, then, is to determine whether . . . there was a "well-settled meaning" of "scheme or artifice to deprive another of the intangible right of honest services" at the time that Congress enacted section 1346 in 1988. . . . [W]e must therefore look to the case law from various circuits that *McNally* overruled in order to determine whether there was a clear meaning of "scheme or artifice to deprive another of the intangible right of honest services" at the time that Congress enacted section 1346, and then determine whether that meaning is sufficiently clear.

United States v. Rybicki, 354 F.3d at 136-37.

Pre-*McNally* private sector honest services fraud cases fell into two general categories (1) bribery and kickbacks and (2) self-dealing. *Id.* at 139. In the bribery and kickback cases, defendants made secret payments, or caused secret payments to be made, to employees of entities with which they had business relationships in exchange for preferential treatment. *Id.* In *United States v. Bryza*, 522 F.2d 414, 415 (7th Cir. 1975), a purchasing agent for International Harvester Company received secret payments from suppliers of goods to his company in violation of his employer's conflict of interest policy. The court found a violation because the defendant held "himself out to be a loyal employee," but, in actuality, had deprived his employer of his "honest and faithful services." *Id.* at 422. Thus, the undisclosed receipt of secret payments was sufficient to amount to a deprivation of the employer's right to honest services, even absent tangible harm to the employer. *United States v. Rybicki*, 354 F.3d at 141.

In the self-dealing cases, the employee typically caused his employer to conduct business with a company "in which the defendant [had] a secret interest, undisclosed to the employer." *Id.* at 140. In *United States v. Von Barta*, 635 F.2d 999, 1003 (2d Cir. 1980), an employee of a securities firm caused his employer to extend credit to an investment fund with "meager capitalization," in which he held an undisclosed fifty percent interest. He also failed to disclose the undercapitalization, even though his employer could be responsible for future losses by the investment fund. *Id.* The

court held that the employee was under a "duty" to disclose "information he [had] reason to believe [was] material to the conduct of his employer's business," because the employer could suffer economic harm. *Id.* at 1007. The outcome of both *Rybicki* and *Von Barta* clearly demonstrate that the nature of the employer-employee relationship is the crux of the analysis, rather than whether a duty was created by state law.

Black v. United States

Conrad Black, the CEO of Hollinger International, Inc., controlled by Ravelston of Canada, owned U.S. and foreign newspapers through several subsidiaries. Black, who owned 65% of Ravelston, and several other executives, were charged with, among other things, devising a scheme to deprive Hollinger of their honest services, by diverting to themselves several million dollars in fees that belonged to Hollinger. In addition, Black was accused of using million of dollars in company assets for personal benefit, including for the renovation of an apartment, using the corporate jet for family vacations to Bora Bora, and for a lavish surprise party for his wife's birthday.

The defendants contended that they did not breach the statute because the Hollinger board had approved the payment of some of the funds to them, and that their intent was to avoid their obligations to Canadian tax authorities and not to financially benefit at the expense of Hollinger. They also sought a jury instruction that would have required the government to prove that it was "reasonably foreseeable to the defendants that the scheme could result in some economic harm" Hollinger. Instead, the trial court submitted to the jury a general verdict form.

Trial Court Decision

At trial, the government advanced two separate theories of mail fraud - fraud by theft of money and property from Hollinger, as well as honest services fraud. *See* Petition for Writ of Cert at 8-9; Brief for the United States in Opposition at 4. The defendants sought a jury instruction that would have required the jury to determine if the alleged "scheme to defraud" Hollinger had resulted in economic gain to the defendants at the expense of their employer.[10] Petition for Writ of Cert at 9. The government alternatively proposed the use of a special verdict form for the jury to identify the theory of mail fraud on which it based its verdict. *See* Petition for Writ of Cert at 11; Brief for the United States in Opposition at 5. The defendants objected and suggested that, in the event of a guilty verdict, the court use post-verdict interrogatories. *Id.*

The court, however, instructed the jury that it could find the defendants guilty of mail fraud if it found that either they (1) stole money or property from Hollinger "by means of materially false pretenses, representations, or promises," or (2) deprived Hollinger and its shareholders "of their intangible right of . . . honest services . . . for private gain for [themselves] and/or a co-schemer." *United States v. Black*, 530 F.3d at 600; Petition for Writ of Cert at 10; Brief for the United States in Opposition at 4. The jury convicted the defendants of three counts of mail fraud without identifying which theory it relied on in returning its verdict.

Seventh Circuit Decision

The Seventh Circuit affirmed the convictions, upholding the government's theory of honest services fraud. The court agreed with the defendants, who had conceded that Hollinger was entitled to their honest services, that as senior executives of the company, they owed it "fiduciary obligations, implying duties of loyalty and candor." It found that the "defendant's unauthorized appropriation of [funds] owed to . . . Hollinger was a misuse of their positions . . . for private gain," precisely what the court had stated in prior decisions "was the essence of honest services fraud," and concluded that there was sufficient evidence to prove that the defendants had stolen money or property from Hollinger by misrepresentations and misleading omissions in violation of 18 U.S.C. §1341. The court also found that Black had breached his duty of candor to his company by causing it to make false filings with the SEC, including Black's own false proxy statement. *Id.* at 599-600 (cit-

ing *United States v. Bloom*, 149 F.3d 649, 655-57 (7th Cir. 1998); *United States v. Hausmann*, 345 F.3d at 955-57; and *United States v. Rybicki*, 354 F.3d at 141-42). Lastly, the court flatly rejected the argument that the defendants were not guilty of honest services fraud because they had only profited at the expense of the Canadian government.[11] *Id.* at 600-01. It explained that Section 1346 did not require the jury to find that the defendants had taken money or property from their company. Rather, all the jury had to find "was that the defendants had deliberately failed to render honest services to [the company] and had done so to obtain a private gain." *Id.*

Action Before the Supreme Court

Although Black is the first case in which that Supreme Court granted certiorari in a private honest services fraud case, it is not the first time that some of the Justices expressed an interest in clarifying this ambiguous statute. In *Sorich v. United States*, 129 S. Ct. 1308 (2009), Justice Scalia dissented from the Court's denial of certiorari, contending that the Court should have "confront[ed]" the meaning and constitutionality of § 1346 because it "has been used to impose criminal penalties on both public officials and private corporate fiduciaries for a "staggeringly broad swath of behavior." *Id.* at 1309. Without consistent limits on the application of the statute, Justice Scalia opined that the honest services fraud statute "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." *Id.* at 1310.

In their petition for a writ of certiorari, the *Black* defendants contended that section 1346 failed to cure the "problems of vagueness and indeterminacy" that led the Court in *McNally* to reject an "intangible rights" theory of mail fraud. Petition for Writ of Certiorari at 17, *Black v. United States*, 129 S. Ct. 2379 (Jan. 9, 2009) (No. 08-876). The defendants maintained that the Seventh Circuit's decision to affirm the convictions without requiring the jury to find that the defendant knew or could have reasonably foreseen that the scheme would cause economic or property harm to the victim "sharply conflicts with the decisions of at least five courts of appeals," noting that the Fourth, Sixth, Eighth, Eleventh, and District of Columbia Circuits had required some showing of economic or pecuniary harm, while only the Fifth, Seventh, and Tenth Circuits had held that evidence was unnecessary. *Id.* at 14-15, 19-20. Because those circuits that rejected the majority view had not adopted any "limiting principle" consistent with pre-*McNally* precedent, nearly any violation of corporate rules could constitute criminal behavior. *Id.* at 21-22. The defendants, therefore, urged the court to "guide the lower courts for the first time" on the scope and meaning of the statute in the private sector context. *Id.* at 23.

The government contended that section 1346 was not limited to schemes to deprive the victim of money or property. *See* Brief for the United States in Opposition at 11. Rather, the fraud was predicated on a deprivation of the intangible rights to honest services, and regardless of whether the defendant was in the public or private sector, it was not necessary to establish any intent to deprive the victim of money or property. *Id.* at 11-12. Further, the government argued that section 1346 was already limited by the requirement that the fraud be "material," a point on which the district judge had properly instructed the jury. *Id.* at 12-13. Thus, in the government's view, an employer would not alter its conduct unless new opportunities for profit or savings, or danger of economic harm, was involved. *Id.* Thus, there was an implicit requirement that the harm caused by an employee's fraud be economic. *Id.*

At the oral argument, several Justices expressed grave concern about the constitutionality of the law because of its inherent vagueness and questioned whether it was possible to fashion any limiting principles. Justice Breyer suggested that merely lying to an employer about something inconsequential, such as whether the latter's hat looked good, could constitute a violation, thus "potentially criminalizing 100 million workers in the United States." Transcript of Oral Argument at 30-31, *Black v. United States*, 129 S. Ct. 2379 (argued Dec. 8, 2009)

(No. 08-876) (hereinafter, "Oral Arg. Tr."). Justice Sotomayor was similarly concerned that an auditor who went to a baseball game on April 14 instead of staying at work on income tax filing eve could be liable under the statute. *Id*. at 36. Indeed, most the Justices struggled to appropriately interpret the statute. Justice Scalia even quipped that he should not have to "turn somersaults" to interpret the statute. Oral Arg. Tr. at 17. Since, the defendants had not specifically briefed the constitutional vagueness issue, Justice Breyer suggested that the parties do so and that the case be considered jointly with *Skilling*. *Id*. at 26-27.

In fact, the recently filed brief on behalf of Skilling does contend that section 1346 "is an unconstitutionally vague statute" because it does not adequately "define the conduct it proscribes so that ordinary persons have notice of what is prohibited, and prosecutors are constrained in what they can prosecute." Brief for Petitioner at 23, *Skilling v. United States*, 130 S. Ct. 393 (cert. granted Oct. 13, 2009) (No. 08-1394). Rather, the statute requires one to review two decades of pre-*McNally* cases in order to understand the meaning of honest services fraud. The "conflict and confusion" present in those cases is what actually led the Supreme Court in *McNally* to require a Congressional definition of "honest services fraud." *Id*. at 22. Thus, Skilling argued that Congress had failed to properly define the crime and the judiciary ought not do so by interpreting the common law. *Id*. at 23 and 53. Alternatively, Skilling suggests that the Supreme Court limit the statute to bribes and kickbacks since that is the "one category of conduct unambiguously prohibited in pre-McNally caselaw," whereas self-dealing "appeared only in a handful of cases and was poorly defined." *Id*. at 23.[12]

If the Court ultimately concludes that the statute is unconstitutionally vague, Congress will have to determine if it should re-enact it with greater specificity. However, if the Court were to either avoid reaching the constitutional question or decide that the statute was constitutional, it will have to determine if the breach of fiduciary duty must be material and if economic harm to the victim is necessary, since the defendants in *Black* had already conceded that they owed a fiduciary duty to their employer. If, on the other hand, the Court determines that the materiality standard does not include economic or pecuniary harm, it will have to also decide if a separate reasonably foreseeable economic harm standard is a valid and necessary limiting principle on the scope of honest services fraud.

Practical Considerations

Even if the Court were to declare section 1346 unconstitutional, the government has other ammunition in its arsenal to prosecute private sector individuals for their criminal conduct, including the mail and wire fraud statutes, bank fraud, securities fraud, and money laundering, albeit these statutes require the government to prove actual harm based on specific conduct.

On the other hand, if the Court determines that section 1346 is constitutional, it will have to sort out the current rift in the circuit courts' interpretation of the statute. At a minimum, the Court will have to address the validity of the limiting principles that have been applied by the appellate courts. If the Court were to follow that approach, prosecutors and defense attorneys alike will have to determine at the outset certain facts, including:

1. Whether an employer-employee relationship exists;
2. Whether there is a fiduciary relationship between the parties;
3. The nature of the conduct at issue;
4. What, if any, misrepresentations or omissions are alleged to have been made during the commission of the acts charged;
5. Whether those alleged misrepresentations or omissions affected the employer's business conduct;
6. Whether the conduct charged was sanctioned or approved by an executive of the employer; and

7. The extent to which the conduct benefited or harmed the employer, and whether the employee received any personal gain or benefit from it.

However, by declaring the statute unconstitutional because of vagueness, the Supreme Court will resolve these issues and eliminate a fundamentally unfair law.

Endnotes

1. The authors would also like to thank law clerk, Samantha Yarbrough, and summer associate, Emily Lipps, for their valuable assistance in preparing this article.

2. In *Black,* the defendants conceded that they had a fiduciary duty, thus the focus of the Supreme Court's review will be what limiting principles should be applied to determine whether criminal liability exists or whether the statute is unconstitutionally vague. In *Skilling*, however, the defendant has disputed that he had a fiduciary duty.

The Supreme Court also granted certiorari in *Weyhrauch v. United States*, 129 S. Ct. 2863 (argued Dec. 8, 2009) (No. 08-1196), where the defendant a public official.

3. Courts have found breaches of fiduciary relationships in a variety of circumstances. The First Circuit found that an employee violated section 1346 when he breached a non-disclosure and non-competition agreement with his employer by releasing confidential information to a competitor. *United States v. Martin*, 228 F.3d 1, 17 (1st Cir. 2000). *See also, United States v. Gray,* 96 F.3d 769, 774 (5th Cir. 1996) (university professors allowed students to plagiarize material and obtain advanced degrees unbeknownst to the university); *United States v. Frost,* 125 F.3d 346, 366 (6th Cir. 1997) (a lawyer failed to disclose to his clients that he received a portion of the fees they paid to a referred physician); *United States v. Hausmann,* 345 F.2d 952,959 (7th Cir. 2003) (a client induced a lawyer to illegally contribute to a congressional campaign); *United States v. Sun-Diamond*, 138 F.3d 961, 973 (D.C. Cir 1998) (lawyer breached fiduciary duty to his firm by devising a scheme that could have damaged the firm's reputation and resulted in loss of business). The Fourth, Ninth and Eleventh Circuits remain undecided.

4. The Second Circuit in *Rybicki* did not, however, decide whether the employer had to be shown to have changed its business conduct in order to support an honest services fraud violation. *See, e.g., United States v. Skilling*, 2009 WL 22879 at *23.

5. Skilling appealed the Fifth Circuit's ruling and the Supreme Court granted certiorari. *Skilling v. United States*, supra, at note 4.

6. Three circuits have yet to decide if honest services fraud can occur without the existence of a fiduciary duty. Each of these appellate courts avoided the issue by finding that a fiduciary relationship already existed. *See, e.g., United States v. Vinyard,* 266 F.3d 320, 327 n.5 (4th Cir. 2001)(employee breached duty to employer by operating a business in direct violation of employer's orders); *United States v. Williams*, 441 F.3d 716, 724 (9th Cir. 2006)(estate and financial planner breached his duty to client by inducing client to give a power of attorney and then using that power to steal client's money); *United States v. DeVegter*, 198 F.3d 1324, 1330 (11th Cir. 2000)(financial advisor breached duty to a county Board of Commissioners by manipulating recommendations in favor of a specific firm who had made secret payments to the advisor).

7. *See United States v. Rybicki*, 354 F.3d at 145 (holding that, although pre-*McNally* case law was not precedential, it was "pertinent" in evaluating the legislative intent of Congress); *United States v. Frost*, 125 F.3d at 364 (holding "that §1346 has restored the mail fraud statute to its pre-*McNally* scope, according to previous opinions interpreting the intangible rights to honest services.").

8. Texas criminal law also makes it a Class A misdemeanor for a public servant with judicial authority to "solicit, accept, or agree to accept any benefit from a person the public servant knows is interested in or likely to become interested in any matter before the public servant or [his] tribunal." Tex. Penal Code Ann. § 36.08(e).

9. *See also United States v. Walker* 490 F.3d 1282, 1299 (11th Cir. 2007)(jurors specifically instructed "not to decide whether Walker violated any state law"); *United States v. Bryan*, 58 F.3d 933, 940 (4th Cir. 1995)(the duty of honest services is defined irrespective of state law).

10. The defendants sought the following jury instruction with respect to honest services fraud - "the government must prove that it was reasonably foreseeable to the defendant that the scheme could result in some economic harm to the victim." Petition for Writ of Cert at 9; *United States v. Black*, No. 05 CR 727, 2007 WL 627236 (N.D. Ill. Feb. 16, 2007) (Defendants' Joint Proposed Jury Instructions) (quoting proposed jury instruction number 34-A).

11. In rejecting the argument, the court remarked that the defendants may have in fact cost the company money. *United States v. Black*, 530 F.3d at 601-02. If the defendants had disclosed to Hollinger's Board and Audit Committee that their recharacterization of fees would result in a higher net income, the company may have decided to reduce defendants' management fees. *Id.* at 602. The court highlighted the fact that the defendant's conduct caused Hollinger to submit false filings to the U.S. Securities and Exchange Commission, which "is bound to get a corporation into trouble." *Id.*

12. In the alternative, the petitioners suggested that the Court "confirm that acts taken in pursuit of the normal compensation incentives offered by the employer to incentivize performance do not constitute the kind of self-dealing criminalized by the statute." Brief for Petitioner at 23. Every pre-*McNally* case "involved actions taken by the employee for private gain," but none defined the private gain to include normal compensation. Since all employees in the private sector "act[] in pursuit of compensation incentives . . . the concept of private gain would render that important limiting principle [as] no limitation at all." *Id.*