Client Advisory | *June 2010*

The United States Supreme Court Scales Back Use of the "Honest Services" Law to Prosecute Corporate Corruption

On June 24, 2010, in a unanimous judgment, the Supreme Court ruled that 18 U.S.C. §1346 ("Section 1346"), also known as the "honest services" statute, can be used only to prosecute fraud involving bribery or kickbacks. To prosecute other misconduct as crimes under this statute would render the statute unconstitutionally vague.[1]

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Enacted in 1872, and later amended in 1909, the original mail fraud statute made it a crime to advance "any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises" through use of the mail. In addition to money and property, Circuit Courts interpreted "any scheme or artifice" to include loss of intangible rights as well. One of these intangible rights became known as the right of honest services. For example, if a corporate officer accepts a bribe from a third party in exchange for a contract, even if the contract's terms were identical to one that was negotiated honestly, the corporation's shareholders would have suffered a loss of their intangible right to have their officers conduct business honestly. The honest service theory targeted corruption where the betrayed party suffered no deprivation of money or property, unlike traditional fraud in which the victim's loss of money or property supplied the defendant's gain.

All federal appellate courts had accepted the honest services doctrine by 1987, when the Supreme Court changed this rule, holding that the mail fraud statute only applied to loss of money or property, and not to intangible rights. In *McNally v. United States*, a state officer, in selecting Kentucky's insurance agent, arranged to receive a portion of the agent's commissions. The state officer was charged with defrauding the citizens of their right to have their government's affairs conducted honestly. The Supreme Court stated that the loss of such an intangible right did not qualify as mail fraud because mail fraud is limited to the protection of property rights. It was Congress' responsibility to enact legislation proscribing the defrauding of citizens by failing to conduct the government's affairs honestly. Congress responded swiftly by enacting Section 1346. Now schemes to defraud included "a scheme or artifice to deprive another of the intangible right of honest services."

Skilling contended in his appeal to the Supreme Court that Section 1346 is unconstitutionally vague. Three of the Supreme Court Justices (Scalia, Thomas, and Kennedy) agreed, reasoning that the pre-*McNally* cases provided no clear indication of what constitutes a denial of the right of honest services, and that federal common law fiduciary duty remains hopelessly undefined. This separately concurring opinion saw no constitutional way or judicial precedent for "paring down" the honest services statute. The Court's majority disagreed. In an opinion by Justice Ginsburg, the Court cited precedent for construing, rather than invalidating, Congress' enactments, and did so here by limiting the reach of Section 1346 to bribe or kickback schemes. The Court characterized these as the core

[1] *Skilling v. United States*, No. 08-1394, 2010 WL 2518587 (2010).

pre-*McNally* applications which Congress sought to restore after the *McNally* decision. With this limiting construction the Court held that Section 1346 constitutionally criminalizes schemes to defraud which involve a bribe or kickback.

The government had charged Skilling with violating Section 1346 through a conspiracy to defraud Enron's shareholders by misrepresenting Enron's fiscal health, thereby artificially inflating its stock price. Skilling allegedly profited from the scheme through receipt of salary and bonuses and through receipt of benefits from the sale of Enron stock. There were no allegations of bribery or kickbacks involved with this scheme. Because Skilling had not engaged in any sort of bribery, the Court ruled that he had not committed honest services mail fraud, and vacated his conviction on that count.

While here a corporate fraud defendant succeeded in greatly narrowing the scope of the definition of honest services, the principal beneficiaries of the *Skilling* Court's decision will be prospective defendants in public corruption cases. Alternative criminal charges arising from alleged corporate misconduct are more readily available without recourse to the honest services statutory definition through securities fraud and related statutes which do not require proof of a bribe or kickback. The *Skilling* case illustrates this, as the Court below must now determine whether Skillings' convictions on the conspiracy count should be reversed, or whether the other two alleged objects of the conspiracy, namely money-to-property wire fraud and securities fraud, permit the conspiracy conviction to stand. And, in addition to the conspiracy conviction, Skilling was also convicted of 18 other counts, including charges of securities fraud, wire fraud, and making false representations to Enron's auditors. By contrast, public officials have duties to avoid conflicts of interest, and disclosure requirements, the breach of which historically have been the basis for fraud charges under Section 1346 without evidence of a bribe or kickback. It will be more difficult for the government to bring such criminal cases in the future without evidence of additional misconduct sufficient to support bribe or kickback allegations.

Congress will determine the ultimate impact of the *Skilling* decision. As it did in 1988 after the Supreme Court's *McNally* decision, Congress may seek to reverse *Skilling* by enacting new legislation, but this time drafting the statute to avoid the vagueness shoal.

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This advisory is for guidance only and is not intended to be a substitute for specific legal advice. If you have any questions regarding the honest services statute, please contact the authors or another member of Edwards Angell Palmer & Dodge's Government Enforcement Practice Group.

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