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Prosecution of Private Corporate Conduct

The Uncertainty Surrounding Honest Services Fraud

By Frank C. Razzano and Kristin H. Jones

Most citizens, as well as lawyers, will be surprised to learn that they can be prosecuted and incarcerated for up to 20 years for what may at first blush seem to be rather trivial conduct, such as failing to comply with the provisions of an employee manual, taking a standardized test for another student, providing a friend with a copy of a popular magazine before it was released to the distributor, or failing to provide detailed information about expenditures to their employer. However, because 18 U.S.C. § 1346 makes honest services fraud a federal crime without defining what constitutes honest services fraud, such prosecutions are not only possible, but occur with disturbing regularity. Prosecutors have come to believe that the amorphous term "honest services fraud" in private sector cases means any lack of integrity in the numerous relationships citizens engage in on a daily basis. In other words, in the eyes of the prosecutor, any dishonesty or lack of integrity or fundamental fairness in any relationship is a potentially criminal form of honest services fraud under 18 U.S.C. § 1346. While the courts and commentators have expressed discomfort with the vagaries of this statute, no court has acted to curb prosecutors' ever-expanding interpretation of the concept.

Typical Honest Services Fraud Cases

A look at some typical cases that have been prosecuted as thefts of honest services reveals the remarkable breadth of the statute. Convictions have been secured against corporate officers and directors who entered into contracts on behalf of their employer with companies in which the officers and directors held an interest, without first advising their employer of that interest. Thus, an intimate knowledge of section 144 of the General Corporate Law of Delaware (dealing with interested director transactions) is no longer sufficient for corporate lawyers. Now a thorough knowledge of honest services fraud is a necessary prerequisite of your practice.

Convictions also have been secured against employees who accepted gratuities from suppliers selling products to their employer. Lawyers have been prosecuted under the honest services fraud theory not only for the obviously criminal act of paying insurance adjusters to expedite insurance claims, but for representing a client competing with another firm client in securing a contract. The government's theory is that an undisclosed conflict of interest constitutes theft of honest services directed at one or the other of the clients.

Issuers of securities that pay brokers additional compensation for selling their stock have been prosecuted for failing to disclose that excess compensation to their customers. Physicians who referred patients to facilities in

which they hold an economic interest or from whom they receive a referral fee have been targeted. One hapless Wisconsin employee was prosecuted for awarding a travel agency contract to the lower bidder because, in the estimation of a federal prosecutor, it violated his interpretation of the Wisconsin Administrative Code. Another, federal employee who worked for the IRS was prosecuted for his idle curiosity in looking at the tax returns of prominent citizens and people against whom he held a grudge, although he made no use of that information.

The Line-Drawing Problem

Because the theft of honest services theory covers such a broad range of conduct from the obviously criminal to that which one would not normally consider a crime, one must ask, where do we draw the line? How can we know when a lack of absolute honesty and candor will result in prosecution? If all dishonesty, lack of candor, or fundamental fairness is captured by honest services fraud, will the following examples lead to prosecution and conviction?

An employer's employee manual prohibits personal calls. Does an employee who in violation of this workplace rule calls her sitter to check on her children become a federal felon? Does an associate at a law firm who writes a complaint letter on firm stationery to a retailer who has sold him shoddy merchandise without approval from a partner commit a crime where use of firm letterhead is generally restricted to firm business? How about the partner who treats the general counsel of a prospective client to a Super Bowl weekend in the hope that the next big case will come his way? Is a salesperson who, without advising the customer of the known difficulties in programming the unit, sells a customer a sophisticated multimedia sound system in order to earn a large commission a potential candidate for the big house? All of these scenarios involve some form of deception and, if the mails and wires are used in the execution of these seemingly common examples, they could potentially be the predicate acts for a federal crime.

The History of the Statute

There is no good answer to the question of when the private conduct just described becomes a federal crime because Congress did not define the term "honest services," and there is almost no legislative history explaining honest services fraud.

The mail fraud statute, 18 U.S.C. § 1341, and wire fraud statute, 18 U.S.C. § 1343, have historically been powerful weapons used by prosecutors to charge a huge range of fraudulent conduct that might otherwise escape more specific criminal statutes. One sitting federal judge has called it the prosecutor's "Colt .45." The original purpose of these statutes was to protect citizens from schemes to deprive them of their money or property. However, in the 1970s and early 1980s, federal prosecutors began extending the mail and wire fraud statutes to criminalize the deprivation of intangible rights, particularly a citizen's right to receive honest services from public servants and an employer's right to the honest services of his or her employees. The U.S. Supreme Court temporarily put a stop to this trend in 1987 in the case of *McNally v. United States*, 483 U.S. 350 (1987), in which the Court held that neither the mail fraud statute nor the wire fraud statute encompassed honest services fraud.

However, the concept of honest services fraud quickly made its way back into the mail and wire fraud analysis when Congress, less than a year later, rushed through 18 U.S.C. § 1346, which defines "scheme or artifice to defraud" under the mail and wire fraud statutes to include "a scheme or artifice to deprive another of the intangible right of honest services." Thus, a new crime of honest services fraud was created with the following elements: (1) a scheme to defraud that includes a material deception; (2) with the intent to defraud; (3) while using the mails, private commercial carriers, and/or interstate wires in furtherance of that scheme; and (4) that resulted in the deprivation of the intangible right of honest services. The meaning of these elements has proven to be just as intangible as the right to honest services the statute is intended to protect.

The fact is the statute provides no guidance on what conduct constitutes honest services fraud. It does not define "honest services." Nor does the statute identify the person or persons to whom this "intangible right of honest services" is owed.

Clarity in the Public Sector

Since the enactment of 18 U.S.C. § 1346, federal courts have tried to step into this gap. They have divided the universe of honest services fraud into two spheres: public and private honest services fraud. Public honest services fraud is the instrument used by federal prosecutors to impose the federal government's view of good government on state and local officials. Since the national government under our federal system cannot pass bribery or conflict of interest laws covering local and state officials, the honest services fraud statute has become its vehicle for enforcing its view of good government on state and local jurisdictions. The theory is that when a local or state official takes a bribe or is embroiled in a conflict of interest, he or she defrauds the people of the state or locality of their right to that public official's honest services.

Fortunately, over time, the circuit courts interpreting honest services fraud in the public sector have been reasonably clear as to what constitutes the theft of honest services. The courts have widely recognized two theories of honest services fraud in public-sector honest services fraud prosecutions: (1) bribery, where a public official was paid for a particular decision or action, or (2) a failure to disclose a conflict of interest resulting in personal gain.

The liberal interpretation of the honest services fraud concept to cover any misrepresentation or omission in relationships between parties not only

Uncertainty in the Private Sector

There is, however, no clarity when the honest services fraud doctrine is applied to private sector cases. In fact, what conduct constitutes a denial of honest services in the private sector remains astonishingly unclear. Rather, an ever-increasing number of individuals and entities are being charged with honest services mail or wire fraud based on what amounts to little more than a prosecutor's own moral determination of right and wrong.

More than 20 years of case law has done little to clarify the extent to which the honest services fraud statute protects people's rights to honest services in the private context. The case law is, at best, inconsistent.

There are a number of circuit splits on critical issues, including what duty must be owed to the victim such that a breach can constitute criminal conduct and what law governs that duty. In other words, while it is clear that the premise of a charge of honest services fraud must be the violation of a duty owed to the victim, it is far from clear what the source of that duty must be for a conviction to be sustained.

Some courts hold that there must be a breach of a fiduciary duty in order for there to be honest services fraud. Other courts reject that notion and state that breach of a fiduciary duty is not an element of honest services fraud. If the courts that hold that a breach of fiduciary duty is required are correct, what fiduciary duty needs to be breached—one under state law or under federal common law? Courts cannot agree on this issue either.

Some courts seem to believe that to have theft of honest services, the defendant must have violated some provision of state law. Many other courts do not require a violation of state law. As with the fiduciary duty standard, if the courts holding that a violation of state law is required are correct, does that mean that a court will determine whether private conduct is a crime based on nothing more than where the conduct occurred? Thus, if courts apply state law standards, a person engaged in the same conduct could be guilty in 50 different ways, or not guilty at all, depending on the laws of an individual state. This leads to the illogical conclusion that whether someone has broken a federal law depends on the laws of the state in which the case is filed.

Another open question is what intent is required under the statute. Some courts require only fraudulent intent, while others have held that intent to achieve personal gain is required. Still others say that intent to cause economic harm is not an element. Some courts require actual tangible harm before a defendant may be convicted. Some courts require that economic harm be reasonably foreseeable. Other courts reject reasonable foreseeability and instead require that the misrepresentation be material. Still others require proof that the defendant inherently harmed the parties' relationship so that where an employee undertakes deceptive conduct that is concomitant with his employer's interests, no crime is committed.

Finally, the Second Circuit has added its own spin to this issue by affirming, en banc, a prior panel's holding that a conviction for honest services fraud could be sustained only where the conduct was enforceable in tort. This holding begs the obvious line-drawing question: When does tortious conduct become criminal?

Defenses Based on the Uncertainty

Given the wide divergence in the courts as to the definition of what constitutes honest services fraud, can any citizen seeking to conform his or her conduct to the requirements of the law ever know which side of the line that conduct will fall on, i.e., criminal or innocent? In *United States v. Brown*, 79 F.3d 1550 (11th Cir. 1996), Judge Edmondson, quoting Sir Thomas More in *A Man for All Seasons* by Robert Bolt, said, "The law is a causeway upon which, so long as he keeps to it, a citizen may walk safely." Yet, given the diverse views of the courts around the country, what citizen can ever know the contours and shape of the road of honest services fraud?

The lack of a clear and uniform standard for what constitutes honest services fraud puts tremendous decision into the hands of the thousands of assistant U.S. attorneys in the 93 districts of this country. Prosecutors have the discretion to interpret the standard as they see fit to essentially create crimes. A federal criminal standard based on theft of honest services is in reality no standard at all as the baseline for what constitutes illegal behavior is not only far from uniform across the country, but a hodgepodge of conflicting rules and elements.

For this reason, there is a compelling argument that the honest services standard fails to give citizens any reasonable notice of the conduct to which we are expected to conform and what constitutes a crime. Arguably, government prosecutions under this theory fail due process and any defendant in an honest services fraud cause would be remiss not to consider a constitutional void for vagueness challenge. Congress, in assigning to federal prosecutors and courts the ability to determine what is fair dealing and honest conduct on an ad hoc basis, may have gone too far.

Remember the hapless Wisconsin employee who was prosecuted for awarding a travel agency contract to the low

draws an ever-expanding criminal dragnet over private parties' conduct, it has broadened their civil exposure as well. Since mail and wire fraud are predicate acts of RICO, two mailings or wires characterized as in execution of honest services fraud may form a pattern of racketeering, imposing liability for compensatory damages, which are trebled under RICO, as well as an award of attorney fees. And, since the corporation employing a would-be fraudster is responsible for acts performed in the course of an employee's employment that benefit the corporation, the specter of corporate liability for RICO is at least a possibility under the honest services fraud theory.

bidder? Her conviction was reversed on appeal and she was immediately ordered released from prison. Similarly, the conviction of the overly curious IRS employee was reversed on appeal because the circuit court determined that unauthorized browsing of taxpayer files was inappropriate conduct but, without more, not criminal conduct. Until such time as the statute is amended or the Supreme Court steps in, the best option for a private individual faced with an honest services fraud charge may be to convert the uncertainty into a defense.

Razzano is a partner at the Washington, D.C., office of Pepper Hamilton LLP, and Jones is an associate at the firm's Philadelphia office. Their respective e-mails are razzanof@pepperlaw.com and joneskh@pepperlaw.com. The opinions expressed in this article are those of the authors and do not reflect a position or endorsement by Pepper Hamilton LLP or any other partner or associate of the firm.

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