VENABLE LLP

government contracts update

SHARE THIS CONTENT MORE ...

www.Venable.com
July 2010

Please contact any of the attorneys in our Government Contracts Group if you have any questions regarding this update.

Authors:

Thomas Madden
tmadden@Venable.com
202.344.4803

Jeffery Chiow
jchiow@Venable.com
202.344.4434

Supreme Court Rules on Honest Services Fraud: Its Decisions Clarify and Simplify Compliance for Government Contractors

The Supreme Court ("Court") today handed down opinions in three cases involving challenges to convictions under the Honest Services Fraud corollary to the mail and wire fraud statutes. It held, in the case of *Skilling v. United States*, that the Honest Services Fraud statute's application must be limited to schemes involving bribes or kickbacks, and cannot be used to prosecute undisclosed conflicts of interest. This holding was the basis for vacating and remanding the other two honest services fraud cases— *Black v. United States* and *United States v. Weyhrauch*.

If you are wondering what honest services fraud is, you are not alone. There has been considerable disagreement among the federal courts of appeals ("Circuits") over what constitutes an act of honest services fraud. The Court's opinions appear to have definitively resolved the differences in interpretation among the Circuits. Several theories and tests were developed by the Circuits in an effort to avoid the conclusion that the Honest Services Fraud Statute was unconstitutionally vague or overbroad. All of those tests were invalidated by the Court's opinion in *Skilling*.

What remains to be seen, is whether Congress will step in, as it did in 1988, to try to salvage the theory of honest services fraud as a tool to combat waste, fraud and abuse. Justice Ginsburg, writing for the Majority in *Skilling*, gave the Congress the same invitation that led to the original passage of the Honest Services Fraud Statute, "If Congress desires to go further, it must speak more clearly than it has."

Background: Passed in 1988, the Honest Services Fraud Statute, was enacted as a Congressional response to a 1987 Supreme Court opinion, *McNally v. United States*. In *McNally*, the Court reversed the mail fraud convictions of a Kentucky state official who had taken part in a kickback scheme. The Court held that mail fraud was limited to schemes to deprive persons of money or property, not honest services. The Honest Services Fraud Statute Congress passed in response states simply, "the term 'scheme or artifice to defraud' includes a scheme or artifice to deprive another of the intangible right of honest services,"—whatever that means.

Before the Court accepted *certiorari* to consider the current cases, honest services fraud became a popular tool for prosecutors and inspectors general in their efforts to combat fraud and corruption. It was alleged in the prosecutions of high profile cases involving lobbyist Jack Abramoff, former Congressmen William Jefferson and Duke Cunningham, Enron executives, and former Illinois Governor Rod Blagojevich. The point of the statute, and what has made it so popular among government attorneys and investigators, is that it made the amorphous concept of "deprivation of honest services" a crime, presumably even where the government could prove no actual economic harm.

The Honest Services Fraud Statute has been used to prosecute conduct by public officials alleged to have deprived the public of their honest services by their involvement in corruption. It has also been used to prosecute corporate officers who allegedly deprived their companies or shareholders of their honest service; and in conspiracy cases, persons have been prosecuted for conspiring with an employee of a separate company (often a vendor) to deprive the separate employee's company of honest service.

The Three Honest Services Decisions: The three opinions, led by the *Skilling* decision set forth a bright line rule that only schemes involving kickbacks or bribery may support an honest services fraud conviction. Other alleged schemes involving the deprivation of honest services are insufficient to substantiate criminal convictions, as they sweep in too much conduct and it is impossible for parties to know what conduct might be deemed criminal. As the Court stated, "Congress intended at least to reach schemes to defraud involving bribes and kickbacks. Construing the honest-services statute to extend beyond that core meaning, we conclude, would encounter a vagueness shoal." Slip Op. at 12.

- *In United States v. Skilling*, former Enron executive Jeffrey Skilling challenged his honest services fraud convictions. Skilling claimed that he had not engaged in self-dealing and had not personally gained from his scheme to manipulate Enron's corporate earnings by fraudulently representing Enron's financial status. The Fifth Circuit, in convicting Skilling, applied the "materiality test." Under the materiality test, which is no longer valid in light of the Court's Skilling opinion, honest services fraud occurred whenever a defendant's misrepresentation had the natural tendency to influence or to be capable of influencing an employer to change his behavior. The Court, in its decision, found such an amorphous concept to be an inappropriate basis for criminal liability. In fact, three Justices, Scalia, Thomas and Kennedy, would have declared the Honest Services Fraud Statute unconstitutional, in its entirety.

  Instead, the Majority opinion, written by Justice Ginsburg limited honest services fraud convictions to schemes involving bribery or kickbacks. Because such schemes are already covered by criminal statutes, the Court's opinion greatly reduces the effectiveness of the honest services fraud theory for investigators and prosecutors. As for Skilling himself, the Court found him not guilty of honest services fraud under the Court's interpretation, and also found that his conspiracy conviction, which incorporated the honest services component, was flawed. However, it remanded his case to the Fifth Circuit to determine whether: (1) any flaw in the conspiracy conviction related to the honest services allegations was "harmless error"; and (2) whether reversal on the conspiracy count would touch any of Skilling's other convictions.

- *In United States v. Black*, newspaper magnate Conrad Black also challenged his honest services fraud convictions. He and fellow executives devised a scheme to mischaracterize certain payments in order to avoid Canadian taxation of the transactions. Black claimed that an honest services conviction was inappropriate because his personal gains were not at the expense of his employer, but rather the Canadian government. The Seventh Circuit decision, which Black challenged, held that where an executive seeks personal gain, the lack of harm to his employer is irrelevant. The Circuit had employed the "personal gain test", which was also invalidated by the Skilling decision. Thus Black's honest service fraud convictions

were overturned.

- *In Weyhrauch v. United States*, a former member of Alaska's House of Representatives challenged his honest services fraud conviction. As part of the same public corruption investigation that involved former Alaska Senator Ted Stevens, Weyhrauch was found to have accepted payments from an Alaskan oil services company in exchange for his votes on legislation affecting the company. Weyhrauch's honest services fraud conviction was based upon his failure to disclose this conflict of interest. He challenged the conviction by saying that Alaska law provides no affirmative duty to disclose conflicts of interest. The Court today vacated the conviction, in a single sentence decision remanding the case to the Ninth Circuit for reconsideration in light of *Skilling*. The failure to disclose a conflict of interest underlying the conviction cannot, after *Skilling*, support an honest services fraud conviction.

As demonstrated by the *Black* and *Skilling* cases, the prior honest service fraud case law led to inconsistent enforcement. Under those prior precedents, it is possible if Messrs. Black and Skilling had switched circuits that neither could have been convicted of honest services fraud. Further, Weyhrauch raised the question of whether the violation of the federal Honest Services Fraud Statute varied from state to state and potentially company to company based upon state ethics laws, regulations or potentially even based upon differing corporate policies.

Mandatory Reporting of Fraud: Since November of 2008, the FAR has required that government contractors report to the appropriate Inspector General, whenever they have credible evidence of a violation of Title 18 of the U.S. Code (*i.e.* criminal laws) involving fraud. At least one representative of the Justice Department has asserted that the FAR requirement may include honest services fraud. Given the differing tests among the Circuits resolved today by the Court, government attorneys and investigators may have previously reached differing conclusions about what constituted credible evidence of honest services fraud. The determination of whether or not credible evidence of honest services fraud exists might even have varied according to where conduct occurred, or where the prosecution was conducted.

In light of today's opinion, even if contractors are required to report violations of honest services fraud, the requirement is no greater than the obligation contractors already had to report kickbacks and bribery. As the Court notes, however, the principal federal bribery statute, 18 U.S.C. § 201 generally applies only to federal public officials, so the Honest Service Fraud Statute's application to state and local corruption and to private-sector fraud reaches misconduct that might otherwise go unpunished.

In 2009 when the Court decided not to hear an honest service fraud case, Justice Scalia took the rare step of authoring a written dissent from the denial of certiorari:

> If the 'honest services' theory—broadly stated, that officeholders and employees owe a duty to act only in the best interests of their constituents and employers—is taken seriously and carried to its logical conclusion, presumably the statute also renders criminal a state legislator's decision to vote for a bill because he expects it will curry favor with a small minority essential to his reelection; a mayor's attempt to use the prestige of his office to obtain a restaurant table without a reservation; a public employee's recommendation of his incompetent friend for a public contract; and any self-dealing by a corporate office. Indeed, it would seemingly cover a salaried employee's phoning in sick to go to a ball game.

Sorich v. United States, 129 S. Ct. 1308 (2009), (Scalia, J.)(dissenting). Justice Scalia's dissent in *Skilling* expressed his belief that the Court's asserted limitation of honest service fraud to schemes involving bribery and kickbacks amounted to a rewriting of the unconstitutionally vague language of 18 U.S.C. § 1346. Further, he argued that, even under the Court's majority interpretation, it was impossible to know whether the Honest Services Fraud statute applied only to federal government officials and government contractors, or whether it reached private corporate conduct, as well.

Practitioner's Tips: While the opinions did not go as far as Justice Scalia and other would have liked, the Supreme Court's decisions provide important guidance to attorneys who advise government contractors. Attorneys should analyze the Skilling decision and change or clarify, as appropriate, reporting guidelines.

Further Information: Venable and the Federal Bar Association are hosting a discussion of Honest Services Fraud entitled, "Honest Services Fraud: What government contractors, government attorneys, and the private bar need to know." The program will be held at Venable's Washington D.C. offices on June 29th, 2010 from 12:00-1:30 pm. Speakers will include government contracts and white collar practitioners, including a representative from the Department of Justice and the Inspector General of the NSA. For information, please visit www.Venable.com/events or download a registration form.

If you have friends or colleagues who would find this alert useful, please invite them to subscribe at www.Venable.com/subscriptioncenter.

CALIFORNIA MARYLAND NEW YORK VIRGINIA WASHINGTON, DC

1.888.VENABLE | www.Venable.com