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SUPREME COURT LIMITS EXPOSURE OF DIRECTORS AND OFFICERS TO PROSECUTIONS FOR HONEST SERVICES FRAUD

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In three decisions issued on June 24, 2010, the Supreme Court of the United States limited a favorite tool of prosecutors—the honest services statute—to its "solid core." Justice Ginsburg, delivering the opinion of the Court in *Skilling v. U.S.*, narrowed the Fifth Circuit's broad interpretation of 18 U.S.C. §1346, which criminalizes "a scheme or artifice to defraud another of the intangible right of honest services," and remanded the case. As a result of its holding in *Skilling*, the Court also found error in and remanded *Black v. U.S.*, and remanded *Weyhrauch v. U.S.* after vacating the judgment.

Skilling was one of the cases developed by the government from its investigation into dozens of Enron employees involved in "an elaborate conspiracy to prop up Enron's short-run stock prices by overstating the company's financial well-being." Specifically, the former Enron CEO was charged with conspiracy to commit wire fraud by denying Enron and its shareholders his "honest services" under 18 U.S.C. §1346. He was also charged with 25 counts of securities fraud, wire fraud, making false representations to Enron's auditors, and insider trading.

In the District Court for the Southern District of Texas, the jury found Skilling guilty of 19 counts, including the honest-services fraud conspiracy charge. The District Court sentenced Skilling to 292 months' imprisonment, 3 years' supervised release, and $45 million in restitution.

Skilling appealed to the Fifth Circuit, based on a number of arguments, including the assertion that he did not violate the honest services statute because, if it was interpreted as including his alleged conduct, it would be unconstitutionally vague. The Fifth Circuit rejected Skilling's argument, but did not address whether the statute was unconstitutionally vague. Accordingly, Skilling sought relief from the Supreme Court.

The Court held that the honest-services fraud law is not unconstitutionally vague when limited to "core cases" of bribery and kickbacks. The Court determined that Section 1346 and its protection of intangible rights was drafted in response to the Court's language in *McNally v. US,* 483 U.S. 350 (1987) limiting the mail fraud statute to the protection of tangible property rights. As such, the Court considered Section 1346 as Congress' attempt to resuscitate pre-*McNally* case law providing a cause of action for violations of intangible rights. The Court determined that the vast majority of pre-*McNally* cases involved offenders participating in bribery and kickback schemes. Rejecting the portion of Skilling's argument—and Justice Scalia's position in his concurring opinion—calling for the invalidation of the statute, the Court chose to construe it. The Court explained that because reading the statute as including other conduct would raise unconstitutional vagueness concerns, the Court held that "§1346 criminalizes *only* the bribe-and-kickback core of the pre-*McNally* case law." Slip Op. at 45 (emphasis in original).

Additionally, the Court rejected the Government's suggestion that it interpret Section 1346 as proscribing undisclosed self-dealing by a public official or private employee. The Court reasoned that conflict-of-interest cases did not constitute core applications of the honest-services doctrine. Furthermore, citing *McNally*, the Court explained that if Congress intended Section 1346 to include such conduct, it should clearly state its intent.

With respect to Skilling, the Court determined that he did not violate Section 1346. The Government never alleged that Skilling solicited or accepted side payments from a third party in exchange for making misrepresentations. In other words, there were no bribery or kickback allegations. Therefore, there was no honest-services violation. Because the indictment

alleged honest-services wire fraud as one of the objects of the conspiracy, the conviction was flawed. The Court remanded the case for a determination of whether the error was harmless and whether a reversal of the conspiracy count would affect any of the other convictions.

With the *Skilling* opinion on the books, the Court remanded two other cases also addressing the issue of the scope of the honest services statute. In *Black*, the former Canadian communications mogul, Conrad Black, was convicted of violating Section 1346 based on duties owed to Hollinger International. The Court held that under *Skilling* an honest services jury instruction was in error because it was not limited to allegations of bribery and kickbacks. Accordingly, the Court remanded the case for a determination of whether the error was harmless. Meanwhile, in *Weyhrauch* the Court cited *Skilling*, vacated the judgment, and the remanded the case with a single sentence.

The Court's conclusion that honest-services fraud claims are limited to cases involving bribery and kickback schemes is important to D&O insurers because it narrows the scope of conduct considered criminal. As many D&O policies include criminal proceedings in their definitions of claims and specifically exclude loss attributable to the commission in fact of any criminal act, the changing definition of criminal acts will affect coverage determinations.

Moreover, by drastically limiting the types of conduct that may be prosecuted under the honest services statute, the Court's decision should reduce the criminalization of certain business practices and help to concretize the charges against which corporate executives may have to defend. Both of these effects should help to reduce the staggering costs of defending such cases.

D&O insurers should monitor Congress for signs that it will amend Section 1346 to address its newly limited application.

Cozen O'Connor is a global leader in representing the insurance industry in all coverage areas. For further analysis of coverage issues involving these cases or D&O coverage issues please contact Angelo G. Savino, in our New York office (asavino@cozen.com, 212-908-1248), or Daniel Johnson, in our Chicago office (djohnson@cozen.com, 312-382-3188).