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WHITE COLLAR CRIME

Circuit Grapples With 'Honest Services' Fraud

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A CLIENT IN THE midst of a nasty contract dispute braces herself for litigation, and litigation she gets, but not exactly in the form she expected. Instead of a summons and complaint, the client is arrested on an indictment brought by federal prosecutors who accuse her of mail and wire fraud for breaching the honest services she owed under the contract. What's more, each of the mail and wire fraud counts carry with it a sentence of up to five years' imprisonment.

The specter of this scenario — the federal criminalization of contract breaches — recently prompted the U.S. Court of Appeals for the Second Circuit, in *United States v. Handakas*, 286 F.3d 92 (2d Cir. 2002), to take the extraordinary step of finding the federal statute that criminalizes "honest services" fraud — 18 U.S.C. §1346 — unconstitutionally vague as applied to that case. Just a few weeks later, the Second Circuit weighed in on "honest services" fraud again in *United States v. Rybicki*, 287 F.3d 257 (2d Cir. 2002), articulating the basic elements necessary to sustain a conviction under the statute.

These efforts to define and to limit "honest services" fraud prosecutions continue a debate that has been raging for more than two decades[1] and that likely will continue, since these decisions raise almost as many questions as they answer regarding the scope of honest services fraud under §1346.

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'Honest Services' Mail Fraud

Honest services mail and wire fraud has had a tortured history. In the 1970s and 1980s, federal prosecutors were allowed to extend the mail and wire fraud statutes to "schemes to defraud … designed to deprive individuals, the people, or the government of intangible rights, such as the right to have public officials perform their duties honestly." See *McNally v. United States*, 483 U.S. 350, 358 (1987). With few exceptions,[2] the prosecutions received little resistance from the courts until *McNally*, when the Supreme Court soundly rejected the "honest services" theory.

In *McNally*, the Court overturned the convictions of a Kentucky public official and a private individual who had participated in a patronage scheme. While acknowledging that the defendants may have deprived citizens of Kentucky of "certain 'intangible rights,' such as the right to have [Kentucky's] affairs conducted honestly," the Court employed the rule of lenity, adopted the less "harsh" interpretation of the mail fraud statute, and held that it was "limited in scope" to the protection of *property* rights, and did not encompass schemes to defraud citizens of their intangible rights of honest services and impartial government.[3]

The demise of the "honest services" theory, however, was short lived. In November 1988, Congress effectively overruled *McNally* by enacting §1346, in large part to ensure that mail and wire would again reach the deprivation of citizen's rights to the honest services of their public officials.[4] The so-called honest services statute provides:

> For the purposes of this chapter [i.e., 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.

18 U.S.C. §1346.

This seemingly straightforward, 28-word statute has caused fits for the courts and the defense bar since its enactment. What, after all, is the "intangible right of honest services"?[5] What "honest services" are owed, and by whom? How are such "honest services" breached? This spring, the Second Circuit addressed certain of these questions in *Handakas* and *Rybicki*, perhaps the two most significant honest services cases in the Second Circuit since §1346 was enacted 14 years ago.

The 'Handakas' Decision

In *Handakas*, in a 2-1 decision, the Second Circuit held — for the first time anywhere — that §1346 was unconstitutionally vague as applied. Handakas had been convicted of a variety of offenses, including mail fraud, for depriving the New York City School Construction Authority (SCA) of its "intangible right to honest services" in connection with general construction contracts that his company had been awarded by the SCA.

As the Second Circuit explained, in performing the contracts, Handakas was required under state law to certify that the "prevailing rate of wages" were paid to project employees.[6] Suffice to say, Handakas failed to pay the prevailing rate of wages and submitted false payroll records that hid that fact from the SCA.[7] While the prosecution also alleged that Handakas had defrauded the SCA of money and property, the jury found that Handakas had committed mail fraud only through the

deprivation of honest services owed to the SCA. On appeal, Handakas argued, among other things, that §1346 was unconstitutionally vague.

Under settled law, for §1346 to be unconstitutionally vague, the court needed to determine that: (1) the statute did not give a person of ordinary intelligence a reasonable opportunity to know what conduct was prohibited; and (2) the statute did not provide explicit standards for those who apply it.[8]

With respect to the first question, the Second Circuit noted that "[t]he plain meaning of 'honest services' in the text of § 1346 simply provides no clue to the public or the courts as to what conduct is prohibited under the statute."[9] The panel cited with approval the view that the phrase "honest services" is inherently undefined and ambiguous, and that no person should be subject to criminal prosecution based upon a statute whose meaning can only be discerned through the "lawyer-like task" of interpreting the conflicting case law on honest services, both before and after *McNally*.[10]

As a result, the court in *Handakas* concluded that, were it the first panel of the Second Circuit attempting to interpret the phrase "honest services" in §1346, it "would likely find that part of the statute so vague as to be unconstitutional on its face."[11] Because two prior Second Circuit cases had considered honest services fraud under §1346, however, the *Handakas* court felt constrained to focus on the constitutionality of the statute as applied to the facts in the case before it.[12]

The court explained that its prior decisions affirming honest service fraud convictions under §1346 did not provide notice to Handakas that the deprivation of honest services stemming from a contractual relationship might violate that section, since those prior cases involved breaches of honest services that could constitute an action in tort, rather than contract.[13] The panel, framing the conduct before it as akin to the breach of the "garden-variety contractual duties usually collected under the rubric of 'representations and warranties,'" concluded that Handakas could not have been on notice that such a breach could support a prosecution under §1346, even though he also violated state law, since neither the contractual nor the state law violation would support an action in tort.[14]

The court next turned to the question of whether §1346 provided "sufficiently explicit standards for those who apply it."[15] After discussing a variety of issues, ranging from the federalization of local crimes and prosecutorial discretion, to the expansive nature of the honest services statute, the Second Circuit concluded that §1346 lacked discernible standards and thus failed the second prong of the vagueness inquiry.[16] Accordingly, the panel held that §1346 was unconstitutionally vague as applied to Handakas and reversed his honest services conviction.[17]

Handakas warrants particular attention for a number reasons. It is the first case ever to find §1346 unconstitutional; it reflects the Second Circuit's overarching concerns on such unrelated issues as prosecutorial discretion, federalism and the unrestrained growth of the federal criminal law. But, such sweeping issues should not obscure the most immediate, direct impact of *Handakas* on future §1346 cases. As described above, the decision makes clear that breaches of honest services based solely on contractual obligations or state court laws and regulations that do not support actions in tort will not be sufficient under the statute. The scope of what conduct will support a §1346 conviction was addressed by the Second Circuit in *Rybicki*.

What seems reasonably clear, however, is that 'Handakas' and 'Rybicki' will not be the last word from the Second Circuit defining the contours of honest services fraud.

'United States v. Rybicki'

Less than five weeks after *Handakas*, a different panel of the Second Circuit addressed yet another §1346 case. In *United States v. Rybicki*, the court acknowledged and expressly agreed with the holding of *Handakas*, but was untroubled in applying §1346 to the facts before it, since the conduct in *Rybicki* involved "the breach of a duty owed by an employee or agent to his employer or principal that was enforceable in an action at tort."[18]

The *Rybicki* defendants, Staten Island personal injury lawyers who had passed money through intermediaries to insurance adjusters to arrange more favorable settlements for their clients, were convicted of various charges, including honest services mail fraud. In rejecting their claim that §1346 was unconstitutional as applied to them, the Second Circuit seized upon the tort vs. contract distinction referenced in *Handakas*, and made clear its view that the constitutional concerns articulated by *Handakas* did not apply to cases where the underlying "dishonest" acts constituted a tort.[19] The court also noted that the *Rybicki* defendants were "sophisticated attorneys" who had demonstrated a "consciousness of guilt," thus suggesting that they were, in fact, on notice of the illegality of their actions.[20]

Significantly, however, the *Rybicki* court also struggled with the vagueness of "honest services," conceding that, "because the statute does not define honest services, the potential reach of §1346 is virtually limitless."[21] Like *Handakas*, the court expressed substantial concern over the need to avoid over-criminalization of private relationships, noting that not every breach of an employee's fiduciary duty to his employer constitutes mail or wire fraud.[22] Given that a literal reading of the statute would seem to imply just that result, the Second Circuit set out to limit the reach of "honest services" fraud.

After considering various ways in which other Circuits have grappled with the vagueness of "honest services" prosecutions, the court concluded that §1346 should be limited by requiring that the scheme to defraud create "a foreseeable risk of economic or pecuniary harm to the victim," that must be more than "de minimis."[23] Thus, the Second Circuit

explained that:

> [t]he elements necessary to establish the offense of honest services fraud pursuant to 18 U.S.C. § 1346 are: (1) a scheme or artifice to defraud; (2) for the purpose of depriving another of the intangible right of honest services; (3) where it is reasonably foreseeable that the scheme could cause some economic or pecuniary harm to the victim that is more than *de minimis*; and (4) use of the mails or wires in furtherance of the scheme.[24]

Review and Outlook

Handakas and *Rybicki* have limited the reach of honest service fraud prosecutions under §1346 in the Second Circuit to breaches of honest services that could support an action in tort, where it is reasonably foreseeable that the scheme to defraud the victim of these honest services could cause some economic or pecuniary harm to the victim that is more than de minimis. Excluded from the reach of the statute are claims where the duty of honest services arises solely from contract obligations, where only intangible harm could reasonably be foreseen from the deprivation of the honest services, and where the only reasonably foreseeable economic harm was de minimis.

Despite these limitations, the reach of §1346 remains murky, and many of the vagueness concerns that were highlighted in *Handakas* remain unanswered.

In the first instance, it is somewhat ironic to suggest that those constitutional vagueness concerns are satisfied by assuming that a person of "ordinary intelligence" can master the "lawyer-like task" of determining whether the underlying duty of honest services was contractual or tort-based, and thus whether the conduct falls within or without the statute.

Moreover, as every first-year law student appreciates, the distinction between duties imposed by contract and by tort is malleable at best. If a contract breach deprives another of honest services, it is not hard to imagine that such conduct could be recast by an aggressive prosecutor as the basis for an action in tort. How such a prosecution will fare under the analysis of *Handakas* and *Rybicki* remains uncertain. Thus, the vagueness concerns inherent in the phrase "honest services" will continue to loom large in prosecutions under §1346.

The *Rybicki* court's attempt to limit the section by adding, as an element, that it must be reasonably foreseeable that the victim could suffer economic harm that is more than de minimis, provides some degree of constraint on the reach of the statute, but appears to be without foundation in the statutory language or legislative history of §1346. *Rybicki* made clear that the lack of actual economic harm, or even the intent to cause economic harm, are insufficient defenses to a honest services fraud prosecution, and implied that reasonably foreseeable harm was broad enough to include the lost time value of money in not completing transactions as promptly as they might otherwise have been concluded.[25] It is unclear what conduct in the private sector could not be recast as satisfying this broad foreseeability test.

Perhaps the most readily identifiable class of cases that may be placed outside the reach of §1346 as a result of this new element are public corruption cases, where officials improperly benefit from their positions, but do so without reasonably exposing the state "victim" to economic harm. Of course, the fact that the honest services doctrine was initially developed to prohibit just such conduct suggests more, rather than less, confusion will follow as courts attempt to implement this new element.

Furthermore, the de minimis standard itself may raise vagueness concerns, as one's view of what constitutes a "de minimis" harm may vary greatly depending on one's perspective. While this standard may provide courts with some latitude to reject cases that are seen as improperly federalizing state civil law, it does little to provide notice to potential defendants about when their conduct will constitute a federal crime.

What seems reasonably clear, however, is that *Handakas* and *Rybicki* will not be the last word from the Second Circuit defining the contours of honest services fraud.

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(1) See, e.g., *United States v. Margiotta*, 688 F.2d 108, 117 (2d Cir. 1982) (Winter, J., dissenting) (objecting to the "limitless expansion of the mail fraud statute"); see also *United States v. Martin*, 195 F.3d 961, 966 (7th Cir. 1999) ("a century of interpretation of the [mail fraud] statute has failed to still the doubts of those who think it dangerously vague").

(2) One of the few critics of the "intangible rights" theory was the Second Circuit's Judge Ralph Winter. See *Margiotta*, 688 F.2d at 117.

(3) See *McNally*, 483 U.S. at 352, 360.

(4) See *Handakas*, 286 F.3d at 104-05.

(5) See, e.g., *United States v. Brumley*, 116 F.3d 728, 733 (5th Cir. 1977) (en banc) (noting that Congress has forced the courts "back on a course of defining 'honest services'").

(6) *Handakas*, 286 F.3d at 96; see also N.Y. Lab. Law §220 (providing that any person failing to pay the stipulated wage scale — i.e., the prevailing rate of wages — is guilty of a misdemeanor).

(7) *Handakas*, 286 F.3d at 96

(8) See Id. at 101 ("In short, the statute must give notice of the forbidden conduct and set boundaries to prosecutorial discretion."); *Rybicki*, 287 F.3d at 263 ("a criminal statute is not impermissibly vague if it provides explicit standards for those who apply it and gives a person of ordinary intelligence a reasonable opportunity to know what conduct is prohibited.").

(9) *Handakas*, 286 F.3d at 104.

(10) Id. at 104-5.

(11) Id. at 104.

(12) See *United States v. Sancho*, 157 F.3d 918, 921 (2d Cir. 1998) (per curiam) (upholding §1346 conviction where the deprivation of "honest services" was based on the breach of a duty to disclose a bribe to the intended victim); *United States v. Middlemiss*, 217 F.3d 112 (2d Cir. 2000) (upholding §1346 conviction where the deprivation of "honest services" was based on the breach of a defendant-employee's duty to act in the best interests of the victim-employer).

(13) *Handakas*, 286 F.3d at 106.

(14) Id. at 106-7.

(15) Id. at 107.

(16) Id. at 109-10.

(17) Unlike the first prong of the vagueness inquiry, which varies by defendant and conduct at issue, this holding rests squarely on the statutory language and thus should apply with equal force to each and every future §1346 case. See id. at 101, 107-10.

(18) *Rybicki*, 287 F.3d at 263-64.

(19) Id. at 264.

(20) Id.

(21) Id.

(22) Id. (citations omitted)

(23) Id. at 265.

(24) Id. at 266.

(25) Id.

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