Scope Of 'Honest Services' Fraud Remains Uncertain

Law360, New York (March 19, 2014, 10:39 PM ET) -- In a recent and significant ruling addressing criminal fraud, the Second Circuit attempted to further define what constitutes “honest services” fraud after the U.S. Supreme Court’s decision in Skilling v. United States. In Skilling, the Supreme Court held that the government could no longer employ the “honest services” theory of fraud unless it could establish the existence of a bribe or kickback.

In its decision in United States v. DeMizio, the Second Circuit held that to be convicted of “honest services” fraud an individual defendant need not receive any direct payment, and that providing a “low-show” job to a party connected to the defendant and providing excessive compensation for the minimal work performed by that party in exchange for favorable treatment from the defendant constituted a kickback.

The second point raises potentially troubling issues. For instance, setting aside ethical and policy issues of nepotism and disclosure, has a company employee responsible for selecting vendors committed “honest services” fraud if a vendor, during the pending of a request for quotation, offers to, and does, hire a relative of the purchasing agent for a prestigious, unpaid internship, even if the relative in fact performs all of her intern duties and responsibilities?

If a client of an advertising firm asks its agency contact to hire a family friend as an assistant, and afterward, more advertising work is steered to the firm, is the employee of the advertising firm risking a criminal investigation even if the family friend performs work for the firm?

Although DeMizio suggests that there is a common-sense, “you’ll know it when you see it” approach to “honest services” fraud when dealing with such situations, it leaves open the possibility that criminal liability may turn on a prosecutor’s or jury’s decision of exactly how much work was performed by the individual, and whether the compensation provided to that individual was commensurate with the work performed.

Background

In Skilling, the government argued that Enron Corp.’s former chief executive officer conspired to commit honest services wire fraud by deceiving investors about Enron’s true financial performance while he, in turn, received increased salary and bonuses. On appeal, Skilling argued that his conviction should be vacated because the statute didn’t adequately define what conduct it prohibited, and it allowed prosecutors to arbitrarily determine what conduct was criminal. The Supreme Court agreed, holding that prosecuting individuals without establishing a link to bribery or a kickback scheme constituted a violation of due process.

The Skilling court excluded from the honest services statute cases where a defendant engaged in self-dealing or nondisclosure of a conflicting financial interest. The Skilling court also explained that the honest services statute drew content from other federal statutes proscribing similar crimes. The question before the Second Circuit in DeMizio was whether payments made to the defendant’s relatives allegedly for their work at “low-show” jobs in exchange for creating, maintaining or increasing
business with DeMizio’s employer constituted such a bribe or kickback.

**United States v. DeMizio**

Darin DeMizio worked for Morgan Stanley in its stock loan department from 1991 through 2005. From 2001 to 2005 he was the head of its domestic stock loan desk, which is responsible for borrowing and lending stock that is necessary for short selling to take place. To transact a short sale, borrowing institutions utilize broker-dealer intermediaries to locate lending financial institutions. These broker-dealer intermediaries sometimes work with finders to help identify lenders.

DeMizio required firms doing business with Morgan Stanley to employ his family members or use finders affiliated with his family members. These family members did little to no work, but the firms added their names to documents recording the transactions with Morgan Stanley. As a result of this arrangement, the third parties increased their business with Morgan Stanley. DeMizio's family members benefited because he caused his employer to overpay these firms for their services. The overage resulting from this premium compensated DeMizio’s family members as well as the firms. The government introduced evidence that payments to these firms amounted to $1.7 million.

In 2008 DeMizio was indicted for conspiring to commit securities fraud and honest services wire fraud, as well as making a false statement to the FBI. The “honest services” wire fraud provision, contained in 18 U.S.C. § 1346, provides that a scheme or artifice to defraud includes a scheme or artifice to deprive another of the intangible right of honest services.

DeMizio argued at trial that his relatives had performed work in exchange for the money they were paid and, as a result, there were no kickbacks or bribes. Instead, he claimed that he had only steered business to these firms. He asked the district court to instruct the jurors that if his conduct did not involve kickbacks or bribes, then they must find harm to the employers of his family members in order to convict him. The district court declined and did not further define honest services in its instruction to the jury.

DeMizio was convicted and appealed to the Second Circuit. While the appeal was pending, the Supreme Court decided Skilling. The Second Circuit stayed and then dismissed DeMizio’s appeal without prejudice and remanded the case to the district court for consideration of its instruction to the jurors in light of Skilling. The district court upheld the initial conviction because the government had relied on a kickback theory during its case, and although its instruction did not reflect the holding in Skilling, the error was harmless because there was no alternative theory upon which the jury could have convicted.

DeMizio once again appealed and argued, among other points, that a kickback was only a kickback if his relatives actually performed no work, and that because he did not personally receive any payment, he could not be guilty of receiving a kickback.

The Second Circuit concluded that although a kickback is often paid by an entity to an employee who steers business to that entity, the fact that payment is made to a third party specified by the employee (or which then passes all or part of the payment to the employee’s designee) can constitute a kickback. Examples of such “favorites” include spouses, family, friends, lovers or others loyal to the employee.

As a secondary point, the court noted that there was evidence that DeMizio’s relatives would have needed his financial support if they had not received the benefit of the arrangement. Thus, it was reasonable to infer that DeMizio did
personally benefit from the arrangement. Moreover, the court rejected DeMizio’s argument that there was no kickback if some work was performed, because such a scenario would allow wrongdoers to shield themselves by performing minimal work.

Implications

The Supreme Court’s Skilling decision does not appear to have narrowed the scope of the “honest services” fraud theory as much as some might have expected. In DeMizio, the Second Circuit endorsed two propositions: (1) that a benefit to a third party can constitute a kickback/benefit to a defendant; and (2) that performance of little to no work can constitute a “low-show” job that may be considered part of the quid pro quo necessary to establish a kickback scheme. The first of these propositions is not especially controversial, while the second is more troubling — particularly for the private sector.

It has long been understood that payments to a third party can constitute the remuneration portion of a kickback scheme. For instance, the former federal statute prohibiting kickbacks in relation to federal contracts stated that a benefit could be conferred “directly or indirectly” on the defendant. Likewise, the federal statute prohibiting theft or kickbacks related to federal programs criminalizes a party’s demand or solicitation of anything of value for “the benefit of any person” with the intent to be influenced.

In Skilling, the court stated that the scope of the honest services statute drew content from such statutes in addition to precedent. Thus, DeMizio confirms what many assumed: After Skilling, alleged bribery or kickback schemes where payments are directed to third-party entities in which an allegedly dishonest employee has an interest will fall within the ambit of the honest services fraud statute.

However, the Second Circuit did not define the scope of what constitutes a “low-show” job that will give rise to a bribe or kickback. Instead, it stated that a scheme qualifies as a kickback scheme where the party receiving payment accepts “inordinate amounts of money for doing minimal work.” The facts of DeMizio and the cases cited to support the court’s reasoning lent themselves to this “we’ll recognize it when we see it” approach.

For instance, evidence presented during the trial of DeMizio indicated that his relatives performed work on only 10 to 20 percent of the transactions for which they were compensated, and that they received more than $1.5 million in payments. However, the lower court noted that the definition of a kickback is broad and can include “any money, fee, commission, credit, gift, gratuity, thing of value, or compensation of any kind.”

It went on to state that even if some of the compensation paid to the party affiliated with the defendant was for legitimate work performed, any payment in excess of that compensation would constitute a kickback if exchanged for favorable treatment. What would be reasonable compensation was left undefined.

The Skilling decision was meant to prevent these ambiguities by limiting the “honest services” theory of fraud in order to provide fair notice of prohibited conduct and to deter arbitrary and discriminatory prosecutions. The lower court in DeMizio dismissed concerns about notice and arbitrary application by reasoning that paying $101 for $1 worth of work was just as clearly a kickback as paying $100 for no work, and that by requiring the intentional exchange of favorable treatment for personal gain, the statute negated the possibility that criminal liability would attach because of overcompensation for legitimate labor.
Conclusion

Where the line will be drawn in future private-sector “honest-services” cases remains difficult to predict after DeMizio. Where virtually no work is performed by, and exorbitant compensation paid to, a person affiliated with the defendant in exchange for favorable treatment presents an easy case. It is more difficult to state with any certainty whether more ambiguous cases will be viewed as crossing the line into criminal conduct. The DeMizio court left such line-drawing to prosecutors and juries. As a result, much of the uncertainty the Supreme Court sought to eliminate in Skilling has resurfaced.

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