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WHITE-COLLAR CRIME

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Outer Limits of Federal Mail, Wire Fraud Prosecutions

Mail and wire fraud, traditionally the darlings of federal prosecutors, have been used to reach a broad range of activity not covered by other federal statutes.

Although courts generally have treated these statutes as elastic with virtually limitless boundaries, two recent high profile cases from the U.S. District Court for the Southern District of New York and the U.S. Court of Appeals for the Fifth Circuit suggest that prosecutors finally may have located the statutes' breaking points.

The Southern District decision in the "Oil for Food" prosecution involved the prosecutors' creative fashioning of a traditional "money or property" wire fraud indictment around the unique provisions of the Iraqi oil embargo. Although sustaining the charges, the district court made clear that the requirement of an identifiable victim—even, perhaps, an enemy country—is one that must be specifically satisfied.

The prosecutors' creativity did not fare as well in the Fifth Circuit's decision in the Enron barge case. There, the court found that to establish the elements of a nontraditional "honest services fraud," the government had to show more than an employee who hoped to line his or her own pockets; it had to establish that the employer was not also an intended beneficiary of the fraud.

The Statutes' Broad Application

The mail and wire fraud statutes, said to "rank by analogy with hydrogen bombs on stealth aircraft,"[1] have been used expansively and creatively by the government since their enactment in the late 1800s. Stretched beyond traditional mails and wires, the statutes now apply to more modern modes of communication such as faxes, modem and Internet transmissions, and provide federal jurisdiction over a broad array of frauds, including not only "consumer frauds, stock frauds, land frauds, bank frauds, insurance frauds, and commodity frauds, but [also]...such areas as blackmail, counterfeiting, election fraud, and bribery."[2]

The government can pursue substantive mail and wire fraud charges under either traditional mail and wire fraud statutes,[3] or under the more recently enacted "honest services fraud" provision.[4] Sections 1341 and 1343, the traditional statutes, cover fraudulent schemes intended to deprive another of "money or property." In response to increased political corruption in the 1970s and 1980s, federal prosecutors attempted to broaden the reach of these sections to include "schemes to defraud ...designed to deprive individuals, the people, or the government of intangible rights, such as the right to have public officials perform these duties honestly."[5]

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The U.S. Supreme Court rejected the "honest service" theory under §§1341 and 1343 in *McNally v. United States*.[6] In response, Congress enacted 18 USC §1346, effectively overruling the Supreme Court's decision in *McNally*, by including in the definition of a "scheme or artifice to defraud" that which "deprives another of the intangible right of honest services." Even with this amendment, however, the statutes are not unlimited.

Oil-for-Food Case: Wire Fraud

In *United States v. Chalmers*,[7] commonly known as the "Oil for Food" case, the government alleged the violation of the wire fraud statute, §1343, against David Chalmers, a Texas businessman, two companies in which Mr. Chalmers was the sole shareholder, and various individuals who worked with Mr. Chalmers. The indictment charged that the defendants paid secret and illegal surcharges to the government of Iraq in exchange for the right to receive allocations for Iraqi oil under the United Nations Office of the Iraq Programme, Oil-for-Food. The defendants were charged with wire fraud, engaging in prohibited financial transactions with Iraq, conspiracy, and violations of the International Emergency Economic Powers Act. In a Feb. 22, 2007 Opinion, District Court Judge Denny Chin addressed the defendants' pretrial motion to dismiss, based in part on the defendants' argument that the government failed to substantiate a claim for wire fraud under §1343.

The Oil-for-Food program was the result of economic sanctions imposed by the United Nations on Iraq following its invasion of Kuwait in 1990. The terms of the sanctions allowed the government of Iraq to sell oil, provided that the proceeds from those sales were deposited into a bank account monitored by the United Nations. Funds deposited into the account were to be used only for the purchase of humanitarian goods for the benefit of the Iraqi people. Only people or entities that held "allocations" granted by the Iraqi government, then under the control of Saddam Hussein, had the right to buy Iraqi oil. Under the Oil-for-Food program, the "allocations" typically were purchased by oil companies or brokers at a predetermined price plus commission.[8]

According to the indictment, in mid-2000, the Iraqi government began requiring recipients of oil allocations to pay a "secret surcharge" to Iraq. These charges, characterized by the prosecution as "illegal kickbacks," were not put into the United Nations Oil-for-Food program bank accounts. Accordingly, holders of the oil allocations found it necessary to demand more money from the purchasers of those allocations to cover their surcharge obligations to the Iraqi government. The defendants are alleged to have paid these inflated commissions in purchasing oil allocations, "with the knowledge and understanding that some portion of these commission payments would be used to satisfy the allocation-holders' kickback obligations to the government of Iraq." By participating in these activities, the defendants are alleged to have diverted money from the Oil-for-Food program and the United Nations' humanitarian efforts.[9]

The defendants moved to dismiss the wire fraud claims against them, arguing that the government had failed to allege all the elements of a §1343 violation. Judge Chin easily found that the indictment contained two of the three grounds that the Second Circuit has held were necessary to establish a wire fraud violation: a scheme to defraud and the use of the wires to further the scheme. Accordingly, the court focused on the third element: whether the indictment sufficiently alleged that money or property was the object of the defendants' alleged scheme to defraud. The prosecution asserted that by participating in a scheme to pay higher surcharges for the allocations, the defendants "caused funds to be diverted from the Oil-for-Food Program Bank Account that otherwise would have been available to purchase humanitarian goods under the Oil-for-Food Program." According to the government, the victims of the scheme were both the Iraqi people and the Oil-for-Food program. The defendants argued that no money was in fact diverted from the program and the indictment failed to allege that either of these "victims" had a valid property interest in the funds allegedly diverted.

The court first addressed defendants' argument that even assuming they paid secret surcharges, the payments could not have diverted money away from the Oil-for-Food program because the surcharge money paid was "above" the amount paid for oil and had no impact on the flow of proceeds to the bank account. The court rejected this argument, ruling that it was required to accept as true the indictment's allegation

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that the scheme diverted money away from the Oil-for-Food program.[10]

Judge Chin then noted that the wire fraud statute requires the existence of a victim deprived of a property interest as a result of the scheme. The prosecution identified two possible victims. The court examined whether the alleged scheme deprived either of a legitimate property interest. With respect to the "Iraqi people," the court rejected the defendants' arguments that the Iraqi people cannot be a victim within the meaning of the statute because they do not have an independent juridical personality under international law and that the recognition of the Iraqi people as an entity separate from the government of Iraq would undermine Iraqi state sovereignty and negatively impact foreign relations. First, the court observed that wire fraud victims are not limited to entities considered "persons" under international law. Second, it found that the location and identity of the victim are irrelevant. Citing the Second Circuit's decision in *United States v. Trapilo*, the court held that the wire fraud statute "reaches any scheme to defraud involving money or property, whether the scheme seeks to undermine a sovereign's right to impose taxes, or involves foreign victims and governments."[11]

Finding that the Iraqi people properly could be victims, the court turned to the issue of whether they had a valid property interest in the funds allegedly diverted from the Oil-for-Food program. Because program money was to be used to purchase humanitarian goods that benefit the Iraqi people, the court determined that they were entitled to the funds and, therefore, had a recognizable property interest. The court similarly concluded that the Oil-for-Foods program could be a victim and held a property interest in the money allegedly diverted from the bank account by the defendants' overpayment of surcharge amounts for oil allocations. Judge Chin denied the motion for dismissal of the wire fraud charges.[12]

§1346: Honest Services Fraud

Cases of mail and wire fraud brought under §1346, the honest services statute, frequently are more nebulous than those brought under §§1341 and 1343. In creating the statute, Congress failed to provide a clear definition of "the intangible right of honest services," leaving courts to delineate the limits of the statute. In its 2002 decision in *United States v. Handakas*, a three-judge panel of the Second Circuit found that §1346 was unconstitutionally vague as applied to the facts of that case. Finding that its prior decisions affirming honest service fraud convictions were limited to breaches that would constitute an action in tort, the court rejected the application of §1346 to the contractual breach which formed the basis of the fraud at issue.[13]

Five weeks later, a full panel of the Second Circuit revisited §1346 in *United States v. Rybicki*. That case involved the breach of a duty owed by an employee to his employer, a breach enforceable as a tort and therefore the valid basis of an honest services fraud charge under §1346, even after *Handakas*. Nevertheless, the court noted that it still struggled with the definition of "honest services" and that not every actionable tort should be liable under the mail and wire fraud statutes. To further limit the scope of §1346, the court imposed the additional limitation that the honest service statute applies only where the "scheme to defraud creates a foreseeable risk of economic or pecuniary harm to the victim that is more than de minimus."[14]

Accordingly, under Second Circuit case law, the elements of a honest services charge under §1346 are: 1) a scheme 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 will cause economic or pecuniary harm that is more than de minimus; and 4) the use of mails or wires in furtherance of the scheme.

The Enron Barge Case

In the Barge case the U.S. Court of Appeals for the Fifth Circuit relied on the Second Circuit's opinion in *Rybicki* in reviewing convictions under §1346 in *United States v. Brown*.[15] The defendants, former Enron employees, were alleged to have engaged in a conspiracy to defraud Enron and its shareholders by "parking" with an investment bank certain Enron assets, specifically, an equity interest in three power generating barges for the purpose of artificially enhancing Enron's year-end earnings.

The investment bank agreed to purchase equity in the barges so that Enron could record $12 million in earnings and thereby enhance its 1999 year-end financials. The government charged that the "sale" was a sham because Enron promised the bank a $250,000 fee and a 15 percent annual rate of return over six months. Enron also promised that if the bank could not find a buyer for the interest, Enron would buy it back. As a result of the allegedly fraudulent scheme, the government claimed that Enron's earnings were artificially inflated and the Enron employees received compensation bonuses.

The government charged the defendants with one count of conspiracy and two counts of wire fraud, one under §1341 and one under §1346. After a six-week trial, a jury convicted the defendants on all counts. The jury, however, was not asked to indicate the basis for its verdict on the wire fraud counts, thereby requiring the court on appeal to find that the government had proven all of its theories in order to affirm the convictions.[16]

On appeal, the defendants argued that the government had not proved a violation of honest service fraud under §1346. The Fifth Circuit stated that "[i]n order that not every breach of fiduciary duty owed by an employee to an employer constitute an illegal fraud, we have required some detriment to the employer." In its case, the government alleged that the employer, Enron, was harmed because: 1) the employees failed to disclose material information—that the barge transaction presented no risk; and 2) Enron paid fees to the bank to effect the deal and compensation bonuses to the employees that were dependent on the completion of the barge deal. In response, the defendants argued that the breach in question actually resulted in an increase in Enron's stock price, an immediate benefit to their employer. Acknowledging the defendants' argument had a ring of truth, the court assumed, for purposes of analyzing the case, that the alleged detriment satisfied that requirement of §1346.

Using existing case law to determine what behavior justifies criminal liability under §1346, the Court examined the Second Circuit's decision in *Rybicki*, referring to the case as the "leading opinion on honest-services fraud." Concurring with *Rybicki's* conclusion that §1346 convictions are categorized in terms of either bribery and kickbacks or self dealing, the Court noted that the facts of the Barge case put it outside that rubric, in "a no-man's land [or] demilitarized zone, in which [it] awkwardly sits alone."

> What makes this case exceptional is that, in typical bribery and self-dealing cases, there is usually no question that the defendant understood the benefit to him resulting from his misconduct to be at odds with the employer's expectations. This case, in which Enron employees breached a fiduciary duty in pursuit of what they understood to be a corporate goal, presents a situation in which the dishonest conduct is disassociated from bribery or self-dealing and indeed associated with and concomitant with the employer's own immediate interest.[17]

Furthermore, the Fifth Circuit found that the personal benefit to the employees—the compensation bonus resulting from the barge transaction —originated with Enron itself, not with a third party as in the case of bribes, kickbacks, or self-dealing.

The Court held that "where an employer intentionally aligns the interests of the employee with a specified corporate goal, where the employee perceives his pursuit of that goal as mutually benefiting him and his employer, and where the employee's conduct is consistent with that perception of the mutual interest, such conduct is beyond the reach of the honest-services theory of fraud as it has hitherto been applied." Saying that the defendants had engaged in dishonest and fraudulent, even criminal conduct, the Court held that the conduct did not fall under §1346. Because the government had failed to prove this theory and the jury did not identify the basis upon which it found the defendants guilty, the Court vacated the convictions.[18]

Conclusion

The vague meaning of the "intangible right of honest services" allows prosecutors some flexibility in charging crimes under §1346. Indeed, prosecutors have broad powers in applying the mail and wire fraud statutes. Defense attorneys representing clients charged under this statute should use the limits set forth in the Oil-for-Food and Barge decisions to ensure that the prosecution does not stray too far from the bribery, kickback and self-dealing cases that traditionally form the bases of mail and wire fraud prosecutions.

1. Ralph K. Winter, "Paying Lawyers, Empowering Prosecutors and Protecting Managers: Raising the Cost of Capital in America," Duke Law Journal (March 1993).
2. See, e.g., *United States v. Zichettello*, 208 F3d 72, 99-100 (2d Cir. 2000) (campaign finance scheme); *United States v. Collins*, 209 F.3d 1, 3 (1st Cir. 1999) (check-cashing scheme); *United States v. Martin*, 195 F.3d 961, 966 (7th Cir. 1999) (Medicare fraud scheme); see also Skye Lynn Perryman, "Mail and Wire Fraud," American Criminal Law Review (Spring 2006) (detailing expansion of mail and wire fraud).
3. 18 USC §1341 (mail fraud); §1343 (wire fraud).
4. 18 USC §1346.
5. *McNally v. United States*, 483 US 350, 358 (1987).
6. Id.
7. __FSupp2d__, 2007 WL 528853 (Feb. 22, 2007).
8. Press Release, United States Attorney for the Southern District of New York, "U.S. Charges Three Businessmen and Two Corporate Entities with Participating in Scheme to Pay Millions of Dollars in Secret Kickbacks to the Government of Iraq in Connection With the United Nations' Oil-for-Food Program," (April 14, 2005).
9. *United States v. Chalmers, et al.*, No. S4 05 Cr.59 (DC), Indictment, 2006 WL 1062917 (May 15, 2006).
10. 2007 WL 528853 at * 3.
11. Id. at * 4.
12. Id. at **5-7.
13. *United States v. Handakas*, 286 F3d 92 (2d Cir. 2002).
14. *United States v. Rybicki*, 287 F3d at 257 (2d Cir. 2002).
15. 459 F3d 509 (5th Cir. 2006).
16. Id. at 518.
17. Id. at 522.
18. Id. at 522-524.