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WHITE-COLLAR CRIME

Expert Analysis

Honest Services Fraud: 'Morris,' 'Skilling' and the Martin Act

By **Elkan Abramowitz** And **Barry A. Bohrer**

In our last article, we discussed the expanding reach of New York's securities fraud statute, the Martin Act, and its questionable application in the New York Attorney General's Office's prosecution of Hank Morris.[1] Mr. Morris moved to dismiss the indictment against him arguing that the Attorney General improperly sought to convict him for what amounted to honest services fraud under the Martin Act, which does not support such a claim. On June 10, the Attorney General's Office filed a 206-page response, paying little heed to Mr. Morris' honest services argument.[2] On June 24, the U.S. Supreme Court decided three cases involving honest services fraud, including *Skilling v. United States*, vacating convictions on the ground that the honest-services component of the federal mail fraud statute criminalizes only schemes that involve bribes or kickbacks.

The Attorney General's Office clearly believes the facts are on its side, responding to Mr. Morris' motion with a lengthy and detailed presentation of the evidence presented to the grand jury that handed up the indictment against Mr. Morris. It describes Mr. Morris' actions as "garden-variety [securities] fraud—concealments, misrepresentations, and non-disclosures of material information that any reasonable investor would want to know"[3]—the very behavior it argues is targeted by the Martin Act. The Attorney General summarily rejects Mr. Morris' characterization of the action as one sounding in honest services fraud. After *Skilling*, such a back-of-the-hand dismissal may not carry the day.

Mr. Morris, who was a paid political adviser to Alan Hevesi while Hevesi was the New York State Comptroller, is accused of engaging in fraud to financially benefit from securities investments made by a division of the New York Common Retirement Fund (CRF) of which the comptroller was the sole trustee. Shortly after Mr. Hevesi took office, Mr. Morris is alleged to have obtained a license as a general securities representative, allowing him to act and receive funds for services as a registered securities agent. The prosecution asserts that Mr. Morris used his position as an associate of the comptroller to direct the CRF investment process, while simultaneously and secretly receiving fees as a placement agent on investments made by the CRF.

ELKAN ABRAMOWITZ *is a member of Morvillo, Abramowitz, Grand, Iason, Anello & Bohrer. He is a former chief of the criminal division in the U.S. Attorney's Office for the Southern District of New York.* BARRY A. BOHRER *is a member of Morvillo Abramowitz and was formerly chief appellate attorney and chief of the major crimes unit in the Southern District U.S. Attorney's Office.* GRETCHAN R. OHLIG, *an associate at the firm, assisted in the preparation of this article.*

The Alleged Fraud

The Attorney General's brief in opposition to Mr. Morris' motion to dismiss describes Mr. Morris' fraudulent behavior as "complex in its execution," but simple at its core. "[T]ogether with the CRF's Chief Investment Officer, David Loglisci, defendant concealed facts, made misrepresentations, and failed to disclose material information so that he could reap millions of dollars in fees as a 'placement agent' on alternative investments by the CRF, as well as hundreds of thousands of dollars in management fees that were paid by the CRF using public funds."[4]

> The parallels between the allegations against Mr. Morris and other honest services fraud cases are apparent.

Noting that fraud is broadly defined under the Martin Act, the Attorney General argues that the evidence submitted to the grand jury of intentional misrepresentations and omissions falls squarely under the Martin Act and is sufficient to sustain the charges. The Attorney General groups Mr. Morris' alleged fraud into four categories. First, Mr. Morris is alleged to have concealed his conflicted role in the subject transactions by hiding the fact that he stood to earn money from the transactions. Mr. Morris accomplished this by funneling payments through other entities or individuals. According to the Attorney General, evidence before the grand jury revealed that CRF investment staff would have given greater scrutiny to the investments in which Mr. Morris was involved if they had been aware of the alleged conflicts.

Second, the prosecution alleges that Mr. Morris made affirmative misrepresentations to private equity firms in order to facilitate the CRF investments that would earn him fees. Third, the Attorney General alleges that the defendant aided and abetted Mr. Loglisci's fraudulent behavior, contending that Mr. Loglisci selected CRF investments in order to enrich Mr. Morris and others and failed to disclose this to CRF staff. Finally, the Attorney General alleges that Mr. Morris was a "functional fiduciary of the CRF who acted as a de facto investment officer" and is therefore liable for breaching this duty by failing to disclose the many conflicts of interest.[5]

Martin Act Issues

In his motion to dismiss, Mr. Morris argued that with respect to each of the Martin Act charges, felony and misdemeanor, the Attorney General was required to prove: 1) a potential injury to property rights; 2) a material fraud or concealment that affected the value or substance of a securities transaction; 3) in the case of an omission, a known and existing duty to speak; 4) the involvement of a security; and 5) Mr. Morris' role in inducing or promoting the specific transaction. With respect to the felony charges, the Attorney General also was required to present sufficient evidence of Mr. Morris' intent to defraud.

• Injury to Property Rights

According to the People, the evidence shows that with respect to the underlying Martin Act felony counts, Mr. Morris wrongfully obtained property as a result of his fraud, namely that the defendant and the corporations he controlled "reaped approximately $19 million in placement fees paid by private equity firms" who did business with the CRF.

Key to Mr. Morris' motion to dismiss is his position that the People improperly are trying to "pair" alleged fraud against one entity (in this case, the CRF) with the taking of property from another (the private equity funds). Mr. Morris asserts that the Attorney General failed to provide proof that Mr. Morris' conduct resulted in any loss, actual or potential, to the CRF. Mr. Morris argues that, without proof of such injury, the Attorney General is seeking to hold him liable for a mere failure to disclose a conflict of interest to the CRF—an unrecognized application of the Martin Act.

The Attorney General's brief in opposition argues that the Martin Act does not require proof that the property fraudulently received be obtained specifically from the victim of the fraud. Rather, the U.S. Court of Appeals for the Second Circuit has expansively interpreted the Martin Act to hold that the source of the money obtained by the defendant is irrelevant.[6] Further, the Attorney General notes that the misdemeanor provisions of the Martin Act do not require that the defendant obtain any property.

Mr. Morris argues that the statute requires more, however. Specifically, he argues that the Martin Act requires proof that he engaged in one of the specified fraudulent practices with the intent to defraud and "thereby wrongfully obtain[ed] property." According to Mr. Morris, "[t]his element of the statute requires more than a simple causal relationship between a fraudulent practice and the obtaining of property. Rather, the defendant commits fraud and 'thereby wrongfully obtains' property, when he obtains the property from his intended victim; or, to put it more simply, when he defrauds the victim of the property."

• Intent to Defraud

Mr. Morris also argues that the fact that the alleged fraud did not "go to the basis of the bargain" between CRF and the private funds proves that he did not have the intent to defraud either the CRF or the private funds. The People take issue with Mr. Morris' interpretation of the intent to defraud element, stating that it wrongfully interprets the plain text of the statute, which requires only that the fraud occur "while engaged in inducing or promoting" the securities transaction at issue, not intent to engage in fraud specific to the essence of the deal. Nevertheless, the Attorney General asserts that even if it were required to prove that the fraud go to the basis of the bargain, the evidence was sufficient to support the grand jury's conclusion that the alleged fraud was more than merely "collateral to" the CRF's investments. Rather, the Attorney General argues they were material to ensuring that the investments would proceed.[7]

• Duty to Speak (the Omission Theory)

Notwithstanding the fact that Mr. Morris was not employed by the CRF and did not have a contractual relationship with CRF, the People assert that Mr. Morris owed a de facto fiduciary duty to the CRF. Mr. Morris argues that—in the absence of a duty under law, rule or regulation to speak or disclose material facts to the CRF—reliance on a de facto duty to speak in a criminal context violates the Due Process clause, as our system of laws "does not require an individual to conduct a fact-intensive analysis" in order to determine whether he owes a "duty to speak" that might subject him to penal sanctions for a failure to speak. Moreover, Mr. Morris notes that a defendant must know of this duty at the time of the alleged offense in order to be held criminally culpable.

The Attorney General dismisses this argument, stating that the evidence was clear that although Mr. Morris did not hold a formal title at CRF, "he wielded enormous authority in deciding which alternative investments the CRF would (or would not) consider and ultimately make, and he was intimately involved in the process of selecting investments."[8] Mr. Morris' involvement was well-known by the private equity firms working with CRF, and the CRF allegedly relied on Mr. Morris a great deal. The Attorney General argues that these facts support the assertion that Mr. Morris assumed a de facto fiduciary duty with respect to CRF and that he was aware of such a duty at the time the alleged omissions were made.

Given the existence of this duty and Mr. Morris' deliberate failure to disclose material facts to the CRF, the Attorney General concludes that Mr. Morris is primarily liable for the alleged fraud and also liable as an aider and abettor. Mr. Morris anticipated this alternative theory of liability in his motion to dismiss, arguing that the New York accomplice liability statute does not permit him to be held liable because Mr. Loglisci did not commit the felony Martin Act offense, as he did not receive property in excess of $250.[9]

Honest Services Fraud

The Attorney General's voluminous brief gives little attention to Mr. Morris' primary and overarching argument that the prosecution relies on an invalid theory of honest services fraud. In short, the Attorney General rejects the notion that its case is an honest services case. Rather than prosecuting Mr. Morris for defrauding individuals of their intangible right to honest services, the Attorney General asserts its reliance on a "straightforward application of the Martin Act to fraud—i.e., 'all deceitful practices contrary to the plain rules of common honesty,'—in connection with securities transactions."[10] For this reason, the People argue that Mr. Morris' reliance on *McNally v. United States*, and case law applying the federal mail fraud statute, is misplaced.

The brief does not directly address Mr. Morris' point that although it has framed its case as securities fraud, at the crux, the Attorney General is pursuing Mr. Morris for a failure to disclose to CRF the fact that he would profit from certain investments. Indeed, the Attorney General refers to Mr. Morris' behavior as the "corruption" of a governmental process—the CRF investment process—and accuses him of "exploit[ing] the investing public" in addition to CRF. These allegations sound, in many ways, like honest services fraud rather than traditional or "garden-variety" forms of securities fraud in which a defendant is accused of making material misrepresentations or omissions in order to manipulate the price of a security.

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Throughout its brief, the Attorney General repeatedly asserts that had CRF staff members and ethics officers known that Mr. Morris was likely to profit from the transactions at issue, they may have made different investment decisions or, at the very least, more deeply scrutinized the transactions. This "injury"—the only direct injury allegedly resulting from Mr. Morris' conduct—certainly has the flavor of honest services fraud cases, as seen in the honest services fraud cases recently considered and vacated by the Supreme Court.

Alaska State Representative Bruce Weyhrauch was accused of depriving the citizens of Alaska of their intangible right to honest services when he failed to disclose conflicts of interest related to legislative votes made in favor of a company that had indicated it would hire him for legal services upon his return to the private sector.[11] Jeffrey Skilling, the former CEO of Enron Corporation, was accused of depriving Enron and its shareholders of the honest services owed by its top employee when he conspired to deceive the public about the state of Enron's financial situation.[12] Like Mr. Weyhrauch, Mr. Morris is accused of failing to disclose a conflict of interest. Like Mr. Skilling, Mr. Morris is accused of depriving the CRF employees and the common fund of material information.

The Supreme Court's holding in *Skilling* arguably goes beyond simply interpreting the federal honest services statute. *Skilling's* holding and reasoning could have profound implications in interpreting the Martin Act, another broadly drafted fraud statute. *Skilling* provides that a general criminal fraud statute, which explicitly refers to honest services fraud, is too indefinite to be applied to cases on concealed conflicts, self-dealing or breaches of duty. Pursuant to that analysis, the Martin Act may not pass constitutional muster, as the act's prohibitions on "fraud, deception, and concealment" appear to lack the definiteness and specificity that *Skilling* demands of any statute governing concealed conflicts, self-dealing or breach of duty.

Much as the Attorney General argues in the *Morris* case, in *Skilling*, the government argued that "undisclosed self-dealing…i.e., the taking of official action by the employee that furthers his own undisclosed financial interests while purporting to act in the interests of those to whom he owes a fiduciary duty" fell within the core of honest services cases historically endorsed by courts, and should similarly be covered by the honest services statute.[13] The Supreme Court rejected that interpretation as constitutionally impermissible, emphasizing that in order to criminalize such conduct, the legislature must speak more clearly than it had in the honest services statute. The Attorney General will be hard pressed to argue that the New York Legislature has spoken any more clearly in the Martin Act.

The parallels between the allegations against Mr. Morris and other honest services fraud cases are apparent. Particularly in light of the cases pending in the Supreme Court at the time of its response, it may have behooved the Attorney General to have devoted more attention to Mr. Morris' honest services arguments. Merely saying that its case is a classic Martin Act fraud case, without more, may not be any more productive than the government arguing that its cases before the Supreme Court fell within the core of honest services cases previously affirmed.

In his motion to dismiss the indictment, Mr. Morris raised legitimate and vexing questions about the viability of a Martin Act prosecution. Those questions remain largely unanswered by the Attorney General. Now, after *Skilling*, those questions loom large, and it remains to be seen whether the Martin Act allegations can survive. Regardless, the case now lies in the hands of New York County Supreme Court Justice L. Bart Stone.

1. Elkan Abramowitz and Barry A. Bohrer, "The Ever-Expanding Martin Act: Has It Reached Its Limit?" NYLJ (May 4, 2010). The authors' firm represents individuals and entities involved in the Attorney General's investigation.
2. Both briefs also address the various other charges in the indictment, including but not limited to scheme to defraud, larceny, enterprise corruption, money laundering, and bribery. These arguments are not the subject of this article.
3. *People v. Morris*, Indictment No. 25/2009, Affirmation and Memorandum of Law in Response to Defendant's Omnibus Motion (People's Brief), at p. 31.
4. People's Brief at p. 29.
5. People's Brief at pp. 30-31.
6. People's Brief at pp. 65-67.
7. People's Brief at pp. 63-64.
8. Interestingly, it does not appear that the Attorney General's memorandum ever directly addresses Mr. Morris' point that "[i]nfluence—even extraordinary influence—is not synonymous with control."
9. According to Mr. Morris, Mr. Loglisci's promotion to chief investment officer as a result of his actions does not satisfy this element.
10. People's Brief at p. 81 (citing *People v. Sala*, 258 A.D.2d 182, 193 (3d Dept. 1999), aff'd, 95 N.Y.2d 254 (2000) (internal citations omitted)).
11. *Weyhrauch v. United States*, 548 F.3d 1237 (9th Cir. 2008).
12. *United States v. Skilling*, 554 F.3d 529 (5th Cir. 2009).
13. *Skilling* at 45.

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