Written Testimony

United States Senate Committee on the Judiciary Hearing: "Restoring Key Tools to Combat Fraud and Corruption After the Supreme Court's *Skilling* Decision"

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Chairman Leahy, Ranking Member Sessions, Members of the Committee, and staff:

Thank you for the opportunity to testify today about the fate of fraud prosecutions in the wake of the Supreme Court's decision in *United States v. Skilling*. I am a professor of law at Duke University and have served on the faculties of the University of Texas School of Law and Washington University School of Law in St. Louis.

For nine years prior to teaching, I served as an Assistant United States Attorney, prosecuting complex federal criminal cases in New York, Boston, Washington, DC and Houston. I spent my last years in the Department of Justice as a member of the Enron Task Force, leading the two-year investigation that produced the initial indictment in the *Skilling* case. While with the Department, I twice received the Attorney General's Award for Exceptional Service.

I will stress two points in my testimony today. First, the problem of defining criminal fraud is both difficult and important. This is not a new problem. It is not limited to the particular linguistic formulation that Congress chose when it enacted the federal "honest services" statute. And Congress must not shy away from continuing to address the challenge of legislatively prohibiting fraud.

Second, the worries raised by the Court's narrowing of the mail and wire fraud statutes in the *Skilling* decision include—but may not be limited to—the possible loss of serious cases of fraud involving breaches of fiduciary duty, both within and outside the corporate context.

Allow me to begin with a quote: "[B]ecause fraud and deceit abound in these days more than in former times ... all statutes made against fraud should be liberally and beneficially expounded to suppress ... fraud."

The date of this quote? 1601. Its author? The famous English jurist Sir Edward Coke, reporting a decision interpreting an Elizabethan statute.

Fraud is, by definition, a form of wrongdoing that evolves rapidly and is committed by actors who design their behaviors with one eye on the constraints of the law. This was true in the 1600s—at the dawn of the Anglo-American legal system and the beginnings of modern markets. It has never been more true than today, after we have witnessed a

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decade marked by a number of massive and elaborate financial deceptions, some dizzying in complexity.

It is neither possible nor wise to attempt to define fraud in overly specific terms. Our legal system has long recognized this. As the Maryland Supreme Court observed in 1872,

> The common law not only gives no definition of fraud, but perhaps wisely asserts as a principle that there shall be no definition of it, for, as it is the very nature and essence of fraud to elude all laws in fact, without appearing to break them in form, a technical definition of fraud, making everything come within the scope of its words before the law could deal with it as such, would be in effect telling to the crafty precisely how to avoid the grasp of the law.

Current U.S. law is, without serious controversy, full of highly general prohibitions against fraud, nowhere more prominently than in our law of securities regulation—a pillar of which is Rule 10b-5's edict against any and all schemes to defraud in connection with the purchase or sale of a security.

There is thus, in my view, a somewhat unrealistic quality to what the Supreme Court said in the *Skilling* case. There is nothing novel, or unworkable, or imprudent about the idea of Congress passing general prohibitions on fraud and the courts working out how to apply those general concepts to new forms of harmful deception as they arise. This process alone presents no special problem of vagueness and due process. If it did, large swaths of American law would have to fall, and fraud would become largely immune to prosecution.

What, then, explains the particular controversy over the "honest services" statute? This brings me to the second point I would like to make today. What has distinguished this statute is its effort to target frauds that involve less tangible harm than simple and direct deprivations of money or property.

This legislative effort alone should not be especially controversial. As our society and economy have become more sophisticated and complex, it has become more and more apparent that information is critical and valuable, and that fiduciary and other trust relationships are both essential to the functioning of a highly specialized economy and subject to harmful abuse. The legal concept of fraud must be permitted to adapt, as it always has, with such changes in society.

The Court's somewhat arbitrary decision in *Skilling* that frauds inflicting less tangible or less measurable harms can only be prosecuted when they involve a bribe or kickback payment risks leaving important forms of abusive deception outside the scope of federal criminal law.

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Suppose that a senior officer of a company uses a loan program, approved in general terms by the board of directors, to spend lavishly and abusively on real estate, art, and luxury goods for him and his family. I am thinking here of the former Tyco chief Dennis Kozlowski.

Or suppose an executive uses a revolving line of credit, extended as a convenience by his company's board of directors, repeatedly and abusively as a means of unloading his holdings in the company's stock. I am thinking here of how former Enron Chairman Kenneth Lay disposed of nearly $100 million in stock as Enron's fortunes were declining, without his shareholders or board of directors knowing what he was doing.

Or suppose that the Chief Financial Officer of a large public company obtains general approval to head up a private investment partnership in order to engage in hedging transactions with the company—and then arranges those transactions to line his own pockets immensely, often with undisclosed and mischaracterized payments. I am thinking, of course, of former Enron CFO Andrew Fastow.

How are such serious cases to be prosecuted? One might say these are securities frauds because they involve public companies. But these are not traditional accounting fraud cases. They are cases of self-dealing, hidden conflicts of interest, and looting of corporations.

Some of the requirements of the law of securities fraud, such as its particular doctrine of materiality, could pose problems for prosecutors in such cases. The government's theories of harm in these cases are not always based on direct impact to the public company's share price. Rather the theories of prosecution are based on the deceptive deprivation from shareholders, directors, and other gatekeepers and stakeholders of the ability to police this kind of conduct and, if warranted, to exit from the relevant fiduciary relationship by firing the actor involved.

Perhaps more significantly, the law of securities fraud is limited to fraud in connection with the purchase or sale of a security. There is no reason why these forms of harmful and deceptive self-dealing and looting cannot arise, with equal seriousness, in institutions and relationships ranging from law firms to hospitals to accounting firms to major non-profit organizations.

I can see no good argument why the federal criminal law of fraud ought to be limited in its application to just that sophisticated and harmful self-dealing that happens to take place in the securities markets.

One might also argue that these kinds of cases can be reached through property theories under the mail and wire fraud statutes and are thus unaffected by the *Skilling* decision. But a prosecutor can often be confronted in such cases with defenses asserting that the general form of the conduct had been approved and that any property obtained by the defendant was within the bounds of such approval.

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The value of the intangible-rights theory of fraud has been that it gets at the essence of these frauds: the deceptive deprivation of important information that could allow a person to exit a trust relationship in which he or she is unknowingly suffering abuse.

In addition and as importantly, abusive self-dealing is not always engaged in directly for profit. A defendant's objective may be to enhance his own power and prestige, or his control over an institution or relationship in which others are depending importantly on him not to engage in abuse—and are counting on transparency to allow them to prevent and control such abuse if it occurs.

There is at least substantial doubt, in the wake of the *Skilling* decision, about whether prosecutors will be able to reach serious cases of this type using deprivation of property theories under the mail and wire fraud statutes. As in the wake of the *McNally* decision over two decades ago, prosecutors have new incentive to argue theories based on intangible forms of property. But such theories were subject to differing treatment in the courts during the period between the *McNally* decision and Congress's codification of "honest services" fraud.

I do not believe that the concept of fraud suddenly becomes unconstitutionally vague simply because it is applied to forms of deception that work less tangible forms of harm. The "honest services" statute became controversial not because of its conceptual structure but because of the occasional but worrisome exercise of prosecutorial discretion to apply the statute to marginal cases that most people would readily identify as not belonging in federal court.

The "vagueness" problem, if there was one, was not so much because the statute was not specific enough about what fraud means as because the law could be used, and was used, against people who could genuinely claim surprise that their minor wrongdoing subjected them to federal prosecution.

The natural outgrowth of such prosecutions was the kind of criticism the statute received at oral argument in the Supreme Court—with some justices, for example, speculating that an ordinary employee could land in federal prison for playing hooky from work. The concern about unconstitutional vagueness, I submit, was really a concern about overbreadth.

I thus want to conclude by suggesting some alternatives that Congress might examine as means of retaining a fraud prohibition flexible enough to deal with serious, novel forms of intangible harm but confined enough to allay fears about overbroad application in the hands of imprudent prosecutors.

First, it has long been a hallmark of criminal fraud prohibitions that they have demanding requirements with regard to mental state. Not only do such laws generally require proof beyond a reasonable doubt of the defendant's specific intent to defraud, but they have often been interpreted—especially in novel contexts—as requiring that the defendant act with consciousness of wrongdoing, that is, with awareness that his conduct is wrongful.

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One might draft a statute that applies only to "willful" violations and, contrary to Congress's usual practice, include within the statute an explicit definition of willfulness that embodies the requirement that violators must know that what they are doing is wrongful (though not necessarily illegal under any specific law). The Supreme Court itself has often observed that actors who are aware of the wrongfulness of their own conduct are not in a position to complain that they have been the victims of surprising application of allegedly vague laws.

Second, Congress might look more extensively at the question of what kinds of relationships tend to involve the serious instances of intangible harm that a federal criminal statute ought to reach. A new statute might be limited to important fiduciary and trust relationships and made inapplicable, for example, to ordinary employment and contractual relationships.

Third, Congress might consider possible thresholds for sorting serious cases of harm from less serious ones. There is no reason not to use statutes to draw clear lines when such lines can readily be drawn. One might choose, for example, to require that the relationship in which the intangible harm occurs be one involving a single transaction or a course of conduct in which the victim had at risk something of a value of at least $50,000.

I do not think this is a magic number, of course, and there are bound to be complications with calculating value. But size thresholds seem like one potential avenue for eliminating some of the trivial and ill-advised prosecutions that had begun to give the "honest services" statute a bad name.

Regardless of whether new legislation is pursued, or of what shape it might take, I urge this Committee and Congress to uphold the centuries-long commitment of our legislatures, courts, and other legal institutions to deal with the ever-challenging and evolving problem of fraud.

Thank you for the opportunity to address you this morning. I am happy to assist the Committee in any further way.

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