Journal of Business & Leadership: Research, Practice, and Teaching (2005-2012)

Volume 6
Number 1 *Journal of Business & Leadership*

Article 8

1-1-2010

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Donoher Journal of Business & Leadership: Research, Practice and Teaching
2010, Vol. 6, 72-77

THE SUPREME COURT CONFRONTS THE GHOSTS OF ENRON: ASSESSING THE PAST, PRESENT AND FUTURE OF CORPORATE FRAUD ENFORCEMENT

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The U.S. Supreme Court ended its 2010 term with a significant ruling on the appeal of former Enron CEO Jeffrey Skilling that sharply curtailed application of the "honest services" doctrine, which had figured prominently in Skilling's conviction. The Court held that the conceptual breadth of the term "honest services" and the apparent inconsistency of rulings applying the doctrine rendered it unconstitutionally vague unless confined to cases of bribery or kickbacks. Notably, Enron and other corporate fraud cases did not involve either form of corruption. This article reviews the development of the honest services doctrine, discusses and analyzes the Skilling decision, and argues that future corporate fraud enforcement is likely to be hindered not only by the specifics of the Skilling decision but also by its underlying ethical philosophy.

What kinds of unethical behavior are significant enough, or reprehensible enough, to rise to the level of criminality, and how do we define that conduct? Broadly speaking, this was the question facing the courts in the wake of the Enron disaster and the subsequent prosecutions of the executives who masterminded one of the most spectacular frauds in corporate history. Before we begin looking more closely at the specifics of the case brought before the United States Supreme Court during its 2009-10 term, let us consider the question posed here in light of the following hypothetical situations:

- A public official steers public business to a certain contractor, who "refunds" a small percentage of the contract proceeds to the official.
- An employer seeking anonymity in certain transactions directs one of its employees to hire an outside entity to act as its contracting representative. The employee instead establishes a new business formed for that purpose, holding it out to the employer as an independent company with the requisite experience and skill to act on behalf of the employer.
- In a series of communications occurring over an extended period of time, a job applicant discloses her employer's trade secrets to the prospective employer.
- An employee fails to disclose certain negative information that would adversely affect the company's stock price and, thereby, the employee's compensation.

Few of us reviewing this list would have significant difficulty deciding that all of these hypotheticals involve behavior that is, at the very least, unethical if not criminally fraudulent. And knowing or believing this, few of us would be likely to act accordingly, whether or not we also took the time to review relevant criminal statutes to determine whether their definitions of criminality fit the facts of our prospective behavior. Indeed, our beliefs likely would lead us to avoid that behavior without reviewing the law first. Here, then, is the focal point of the dilemma of legal definition, and the question to which we will return at the end of this article: If the purpose of the law is to provide notice of criminality, but most of us inherently recognize the existence of circumstances that would, at best, be questionable or unethical, who will review the law first, and with what motive?

Although most of us are, indeed, likely to avoid situations such as those described above, all of these hypotheticals represent actual cases prosecuted under what has come to be known as the honest services doctrine. Thus, someone acted unethically or criminally in each of these cases, and all were convicted as a consequence. The first scenario involves one of the most common forms of corruption, that of the public official who abuses his or her office for personal gain. The last scenario generally describes the Enron fraud. Notice that each involves a somewhat different contextual and factual background, but all invoke our common concern with unethical or criminal behavior. And yet, under the Supreme Court's review of Jeffrey Skilling's conviction, only the first of these clearly would be covered by the honest services doctrine, which, as the Court held, can now only be applied to cases involving bribery or kickbacks.

This article surveys the honest services doctrine, summarizes and evaluates the Supreme Court's decision in Skilling's appeal, and assesses its likely future impact. With regard to the latter, the central argument advanced here is that, although alternative theories of liability or criminality might apply to any or all of the remaining scenarios described above and to similar future cases, the Court's ruling effectively limits prosecutors' latitude in pursuing and prosecuting fraud, and thereby limits the deterrent value of fraud enforcement. Discussion begins below with a look at the origin and development of the honest services doctrine, after which the Skilling decision and its future impact will be considered.

THE PAST: THE ORIGIN AND EVOLUTION OF THE HONEST SERVICES DOCTRINE

What we have come to know as the honest services doctrine traces its lineage to the original U.S. mail fraud statute (18 U.S.C. 1341), which was enacted in 1872. Although honest services did not come into being immediately upon enactment of this statute, the doctrine has been developing for roughly a century and therefore should not be seen as a completely new and unwelcome addition to the law. To understand this evolution, we need to return to the language of the statute and follow its interpretation by the courts.

Today's version of Section 1341, following several amendments over time, reads in pertinent part as follows:

> Whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises,…places in any post office or authorized depository for mail matter, any matter or thing whatever to be sent or delivered by the Postal Service, or deposits or causes to be deposited any matter or thing whatever to be sent or delivered by any private or commercial interstate carrier,… shall be fined under this title or imprisoned not more than 20 years, or both….

Clarity and parsimony of expression obviously were not fully appreciated or valued by Congress, and in fact the ambiguities of the statute's language long have been noted. What is a "scheme or artifice to defraud"? Exactly what kinds of representations or actions are to be considered provable as "false or fraudulent pretenses"? For that matter, what is meant by "property"? Indeed, it is precisely questions such as these that brought the issue of the statute's interpretation to the fore in Skilling's appeal.

For our purposes, it is important to focus on the first two clauses of the statute and the sequence of their adoption. The initial version of Section 1341 omitted the second clause covering those "obtaining money or property by means of false or fraudulent pretenses, representations, or promises." Thus, as originally enacted, the statute applied only to "any scheme or artifice to defraud"—leaving open the question of what constituted a "scheme" or "artifice." In 1909, the statute was amended to add the "false or fraudulent pretenses" clause. The question of what kinds of activities actually were covered by the law remained undefined, and it is a fair question whether this amendment otherwise clarified or further confused the original meaning and intent.

In reviewing the statute, courts began to interpret the separate clauses as applying to different kinds of acts. Statutory interpretation generally assumes that different parts of a statute have independent meaning unless they are stated as simply providing examples or clarification. In the case of Section 1341, the two clauses in question were enacted at different times, suggesting that Congress had different things in mind even though both arguably could be construed as "fraud" broadly defined. Further support for this assumption was provided by the drafters' use of the conjunctive "or" in the 1909 amendment adding the second clause, which courts quickly interpreted as suggesting that the offense condemned by the law could be found in either one of the two clauses.

Observing that the English language may be read in this manner does not, of course, address the ultimate question of meaning. But when read closely, Section 1341 seems to suggest that the two offenses in question relate to fraud, on the one hand, and false pretenses, on the other, if both clauses are to be given independent meaning. What is significant in this dichotomy is that fraud basically describes a relationship between two parties, one of whom gains and one of whom loses the amount in question. In other words, it is a zero-sum arrangement in which the loss of one flows directly to the benefit of the other. By contrast, whatever is meant by "obtaining money or property by means of false or fraudulent pretenses, representations, or promises" is not confined to such a zero-sum relationship. If you hire me to do a particular job, and I do that job but also leverage my position to gain side benefits, you have not lost nor have you supplied my gain. A third party is involved in this scenario.

This was precisely the reasoning of the Fifth Circuit Court of Appeals in *Shushan v. United States*, 117 F.2d 110 (1941). (By way of background, the federal court system is comprised of three levels, with the Supreme Court at the top, followed by the 12 circuit courts (11 regional courts plus the D.C. circuit), and finally the various district courts sitting in each state. The latter are the system's trial courts. The circuit courts review the district courts' findings of law and issue rulings that are binding within the boundaries of their individual jurisdiction. Circuit court rulings thus have no binding effect in other circuits, but may serve as important precedents for rulings by other circuit courts. Note that this may create conflicts in the law, where one circuit court rules one way on a particular issue while another adopts a different rule. One of the functions of the U.S. Supreme Court, should it decide to accept an appeal from the circuit courts, is to resolve such conflicts between the circuits.) There, the defendant engaged in essentially the same scheme described in the first scenario at the beginning of this article. The Fifth Circuit observed that "[i]t is not true that because the [city] was to make and did make a saving by the operations there could not have been an intent to defraud" (*id.* at 119) that would rise to the level of condemnation under Section 1341. Again, note the existence of the third-party, non-zero-sum relationship exhibited in this case, which is distinct from the zero-sum arrangement we typically associate with two-party fraud. This ruling became the basis for what we know today as the honest services doctrine.

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But there remained a troubling issue of context in cases such as these: Did the statute apply only to public corruption, or could private employment relationships be subject to its coverage as well? Note that *Shushan* involved a case of public corruption, which had been the traditional basis for cases brought under Section 1341. For the most part, the public policy underlying prosecutions was to target public officials who abused their offices for private gains. Even though true as a matter of practice, nothing in the statute explicitly limited its reach to public corruption. Indeed, courts seem to have begun the extension of Section 1341 to the private employment context in 1942, shortly after *Shushan* was decided (e.g., *United States v. Procter & Gamble Co.*, 47 F. Supp. 676, 678 (Mass. 1942)), and by 1982 all of the circuit courts had adopted the honest services doctrine and its extension to the private realm (Coffee, 1983; Hurson, 1983).

What seemed to be a settled legal principle was unceremoniously halted in 1987, when the U.S. Supreme Court considered the case of a state official who chose the state's insurance agent and attempted to have the agent pay a kickback on its commissions to outside companies partially owned by the official. In *McNally v. United States*, 483 U.S. 350, 362-364, 107 S. Ct. 2875 (1987), following the approach and logic of the honest services doctrine, the state had not alleged that, "in the absence of the alleged scheme [,] the Commonwealth would have paid a lower premium or secured better insurance." Instead, the prosecutor argued that the kickback scheme "defraud[ed] the citizens and government of Kentucky of their right to have the Commonwealth's affairs conducted honestly." *Id.*, at 353, 107 S. Ct. 2875. Note again the lack of a direct relationship that is common to traditional fraud; once more, the scheme involved a third party who supplied the benefit to the state official.

Nevertheless, the Supreme Court struck down this aspect of the honest services doctrine. "Rather than constru[ing] the statute in a manner that leaves its outer boundaries ambiguous…," the Court read the statute "as limited in scope to the protection of property rights." *Id.*, at 360, 107 S. Ct. 2875. "If Congress desires to go further, it must speak more clearly." *Ibid.* The decision thus seemed to read out of existence the second clause of Section 1341, or to conflate its meaning with the first clause and interpret both jointly. The result was that honest services prosecutions were no longer permissible.

As it happened, Congress responded to *McNally* immediately, passing a new Section 1346 in 1988 to "speak more clearly" on the subject of honest services. The new statute read:

> For the purposes of this chapter, the term "scheme or artifice to defraud" includes a scheme or artifice to deprive another of the intangible right of honest services.

The intent clearly was to read back into the law, in explicit fashion, the doctrine of honest services, but without additional definitional clarity. The obvious question remained, strictly on the basis of the statutory language: What does "honest services" mean? In circumstances such as these, the common approach is to incorporate the body of law as developed, so that in regard to the honest services doctrine, and in direct response to *McNally*, the decisions applying honest services to third-party arrangements in addition to traditional fraud and to both private and public relationships were reinstated.

This brought to a close the evolutionary period of the honest services doctrine. As suggested above, the principle traces its origin to statutes enacted a century ago, and in its more mature formulation to decisions and rulings that date from the early 1940s. Even viewed from the perspective of the newer Section 1346, which for the first time explicitly read the phrase "honest services" into the statute books, the doctrine has survived for more than 20 years. In all this, it is important to note that application of the doctrine is, or should not, be a surprise, even if the precise acts contemplated are not spelled out in precise detail. There is a principle underlying the doctrine, which, if not delineated in stark language is, or should be, nonetheless apparent to those seeking guidance from the law. Until Enron, that is.

THE PRESENT: ENRON, SKILLING AND THE REDEFINITION OF HONEST SERVICES

By now, Enron is somewhat old news, but by the time of its demise and in the months and years immediately thereafter it was one of the most widely publicized firms in American commercial history—first for its seemingly unparalleled success, and then for its equally unparalleled chicanery. Very elaborate mechanisms had been established by the company involving off-balance-sheet transactions with various entities ultimately connected to Enron itself, if only one could penetrate the maze of complexity. In fact, despite limited disclosure in its public filings, replete with obscure references but lacking factual detail, a clear picture of the company's finances was impossible to obtain. And yet other activities were successfully hidden completely. The net effect was to give the appearance of success, even though that success was precariously balanced on a mountain of debt and other obligations that could bring down the house of cards at a moment's notice. Of course, that is precisely what eventually transpired.

The various Enron executives were pursued and prosecuted. Ken Lay, the company's chairman, suffered a heart attack while incarcerated. Jeffrey Skilling, the CEO, continued to appeal his conviction, ultimately succeeding in coming before the Supreme Court during its 2009-10 term. The Court had this to say in summarizing the factual background of the case in its ruling issued on June 24, 2010:

> Founded in 1985, Enron Corporation grew from its headquarters in Houston, Texas, into one of the world's leading energy companies. Skilling launched his career there in 1990 when Kenneth Lay, the company's founder, hired him to head an Enron subsidiary. Skilling steadily rose through the corporation's ranks, serving as president and chief operating officer, and then, beginning in February 2001, as chief executive officer. Six months later, on August 14, 2001, Skilling resigned from Enron.
>
> Less than four months after Skilling's departure, Enron spiraled into bankruptcy. The company's stock, which had traded at $ 90 per share in August 2000, plummeted to pennies per share in late 2001. Attempting to comprehend what caused the corporation's collapse, the U.S. Department of Justice formed an Enron Task Force, comprising prosecutors and FBI agents from around the Nation. The Government's investigation uncovered an elaborate conspiracy to prop up Enron's short-run stock prices by overstating the company's financial well-being. In the years following Enron's bankruptcy, the Government prosecuted dozens of Enron employees who participated in the scheme. In time, the Government worked its way up the corporation's chain of command: On July 7, 2004, a grand jury indicted Skilling, Lay, and Richard Causey, Enron's former chief accounting officer. These three defendants, the indictment alleged, "engaged in a wide-ranging scheme to deceive the investing public, including Enron's shareholders . . . about the true performance of Enron's businesses by: (a) manipulating Enron's publicly reported financial results; and (b) making public statements and representations about Enron's financial performance and results that were false and misleading." Skilling and his co-conspirators, the indictment continued, "enriched themselves as a result of the scheme through salary, bonuses, grants of stock and stock options, other profits, and prestige." (Skilling v. U.S., 130 S. Ct. 2896, 2907 (2010)).

As a result, prosecutors said, Skilling had deprived the company and its shareholders of the intangible right of honest services, citing directly to Section 1346. In addition, Skilling was charged with more than 25 separate offenses, including insider trading, securities fraud, wire fraud, and making false representations to auditors.

Skilling eventually was convicted, but appealed, raising claims based on the lack of a fair trial and the coverage of Sections 1341 and 1346. In particular, he claimed that the actions of which he was accused did not constitute a conspiracy to commit honest services fraud, and in the alternative that the statute was unconstitutionally vague. The Court upheld the fair trial rulings of the lower courts, and turned to the question of the honest services doctrine.

As an initial matter, the Court declined to invalidate Section 1346, preferring instead to rely upon the general rule of law favoring construction and interpretation. The question for the Court then became defining the proper meaning and limits of the honest services doctrine, given the need for constitutional consistency. In other words, whatever the meaning of the statute, it had to pass constitutional muster. Returning to the *McNally* decision and the subsequent adoption of Section 1346, the Court observed that the statute was designed to reinstate pre-*McNally* jurisprudence.

The Court could have ended its analysis at that point, suggesting that, whatever the limitations of the language, courts prior to the *McNally* decision did not seem to encounter serious issues of indeterminacy. Nor had vagueness challenges been readily entertained, at least successfully. In short, looking at the body of the law as it existed prior to *McNally* and the adoption of Section 1346, there was nothing that compelled further decision.

But the Court continued:

> In parsing the Courts of Appeals decisions, we acknowledge that Skilling's vagueness challenge has force, for honest-services decisions preceding *McNally* were not models of clarity or consistency….While the honest-services cases preceding *McNally* dominantly and consistently applied the fraud statute to bribery and kickback schemes -- schemes that were the basis of most honest-services prosecutions -- there was considerable disarray over the statute's application to conduct outside that core category. (*Id.* at 2929.)

Thus, in order to avoid unconstitutional vagueness, the general, or core, purpose and rule of the doctrine would be invoked: Since most cases decided before *McNally* and the adoption of Section 1346 involved bribery or kickback schemes, that must necessarily be the core meaning and understanding of the doctrine. Application of the law beyond those kinds of situations would not be able to be anticipated by potential defendants, and thus would fail on vagueness grounds.

In a separate concurrence, Justice Scalia argued in favor of outright invalidation. The cases and standards applied in previous rulings, he maintained, were hopelessly inconsistent and arose in a multiplicity of contextual circumstances that would not afford a defendant a sufficient opportunity to adjust his or her behavior. Thus, as a matter of due process, Scalia believed that the entire statute should be set aside.

It is important to note that the Court did not overturn Skilling's conviction. Rather, it sent the case back to the lower courts for a precise definition of the basis of his conviction. Given that multiple counts and theories were advanced, the record was not sufficiently clear as to the extent to which the conviction relied upon honest services in whole or in part. If Skilling had been convicted on grounds other than honest services fraud, that part of the conviction would stand. To the extent that his conviction was grounded on honest services, though, the Court's ruling would result in acquittal since the case did not involve bribery or kickbacks under the new rule. As of this writing, we will have some time to wait before the issue is resolved and Skilling's final status decided. But it is indisputable that the honest services doctrine is now more limited than had previously been the case.

THE FUTURE: EVALUATING THE DECISION AND ITS IMPACT ON FRAUD ENFORCEMENT AND PREVENTION

As Skilling's case shows us, other grounds for conviction of miscreants often are available in prosecutions of fraud and related offenses. As a consequence, it is tempting to view the *Skilling* decision as nothing more than a technical refinement of an arcane, and possibly inconsequential, area of the law. To an extent, this is a fair assessment, for the Court's decision surely was correct as far as the narrow issue of definitional clarity is concerned. The statute's wording is ambiguous if we view the matter as one requiring absolute certainty of the action-reaction sequence, and indeed many commentators were concerned by the prospect of overzealous prosecutors pushing the limits of construction to cover more and more "offenses" (e.g., Parloff, 2010). Balanced against the observation that other theories of legal liability may still be pursued, the prospect of abusive prosecution would seem to argue in favor of a narrow interpretation.

But the Court's reasoning in *Skilling* may still be criticized on two grounds, one legal and one normative. In terms of the legal analysis employed by the Court, the approach of stripping a statute's interpretation to its core principles and applications works only in cases of limited variance. That is, where circumstances are such that absolute consistency in interpretation and practice point to a given result or orientation, such a step may make sense. (This does not resolve the issue of whether courts *should* engage in such a practice; Scalia's concurrence and the majority opinion engaged in a sharp debate about this issue, which remains beyond the scope of this article.) But if that is the case, why is there a need to specify a core interpretation at all? In fact, most statutes probably do not fall into this category in the first instance, meaning that a court's resort to core application may be more arbitrary than any opinions rendered under existing precedent. This seems to be the case in *Skilling*: There were indeed a variety of contextual parameters and fact patterns prosecuted at various times under Sections 1341 and 1346. To say that a majority involved bribery or kickbacks is correct, but is not a basis for creating a firm rule that limits future application of the statute. Many cases, such as Enron, did not involve these particular offenses, yet exhibited obviously culpable behavior. For that matter, if we are searching for some majority principle, why stop at the form of corruption? Most cases brought under Sections 1341 and 1346 arose in the public sphere. Why then did the Court not point to this further distinction in announcing the "core" purpose of the statute? In all of these instances, the Court seems to be confusing context with substance in announcing a substantive rule of law.

This leads to the second ground for concern: What is the normative impact of Skilling? Recall once again our opening scenarios above, and consider the ramifications of the present decision for all but the first. What impact will the announcement of this rule have on potential perpetrators of similar deeds? Let us further suppose application of a similar approach to enforcement to traffic law: If the speed limit stays the same (whatever it may be), but everyone "knows" that no one will be prosecuted for driving 5-10 miles per hour over the speed limit, what will be the result in terms of behavior? In fact, we see this on our highways everywhere. Now suppose that it is announced that radar will no longer be used. Other enforcement methods remain available for use (observation, "tailing" to estimate speed, etc.), but only radar will be outlawed because it is inherently subject to user interpretation and potential error. Will the incidence of compliance with the underlying speed limits, even within the existing 5-10 mile per hour "grace" zone, be likely to increase or decrease? In the realm of corporate fraud, this seems to be the end result of the logic of *Skilling*.

There is also a larger normative value at stake in the context of corporate fraud, one that is partially disclosed by the hypothetical discussion above. Most of us know what proper behavior is, independent of black-letter law. Certainly, most of us would have known that activities such as those that occurred at Enron were morally, ethically, and legally culpable. Would the definitional certainty demanded by *Skilling* have made a difference? On the other hand, to one engaged in such activities, knowing the precise definition could have made all the difference, but only in terms of knowing how to shape those activities to avoid coming within the ambit of the statute. In fact, in terms of the ethical foundation of the law, the statute really was not vague prior to the Enron litigation, and its increased clarity now is likely only to be of service to those contemplating future schemes.

In essence, the Court is imposing a rules-based jurisprudence that may be at odds with a more principles-based approach. The same approach was used in crafting the Sarbanes-Oxley financial reporting legislation, and was criticized at the time (and still is today) for being overly rules-driven (e.g., Rockness & Rockness, 2005). But rules can always be circumvented; principles are more elastic in their application but arguably more representative of the underlying ethical foundation and behavior they are intended to enshrine (see e.g., Kant, 1964). At a time when scholars are recognizing the increasing need to focus on character and values (e.g., Wright & Goodstein, 2007), and when evidence of behavioral abuses in the boardroom and the executive suite is accumulating (e.g., Donoher et al., 2007; Dunn, 2004; Kang, 2008; O'Connor et al., 2006), the abrogation of a principles-based jurisprudence is troubling. Even if other enforcement mechanisms exist, the removal of one tool whose elasticity in fact was an advantage in terms of enforcement and deterrence cannot aid enforcement or the prevention of fraud. The rules-oriented approach advocated in *Skilling* opens the door wider to the clever miscreant whose imaginative, but not clearly prohibited, malfeasance awaits discovery at some future point in time.

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