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JUDGMENT CALL

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SECTION 1348 STRIKES BACK

FIVE YEARS AFTER SARBANES-OXLEY, AN OBSCURE STATUTE HAS BECOME INCREASINGLY IMPORTANT, IF REPLETE WITH LEGAL LIMITATIONS

SECTION 1348, THE CRIMINAL SECURITIES FRAUD law enacted as part of the Sarbanes-Oxley Act on July 30, 2002, was intended to provide a “more general and less technical” option that would be “more accessible to investigators and prosecutors” than existing anti-fraud laws.

However, despite the congressional enthusiasm for this new statute, prosecutors have scarcely utilized Section 1348 in its first five years of existence.

But this may soon change.

As time passes, prosecutors will no longer have to worry about the ex post facto (or retroactive) issues that would be raised by using Section 1348 to prosecute conduct that pre-dates SOX. Also, because courts are starting to review Section 1348 in the handful of cases brought under the statute, prosecutors will be more comfortable putting it to use.

The possibility that prosecutors may use Section 1348 more raises important issues about the scope of the statute. For example, prosecutors will likely argue that, unlike Section 10(b) and Rule 10b-5, Section 1348 does not require proof of a willful mens rea (commonly defined as the conscious realization one is breaking the law).

Sarbanes, Oxley
best intentions

This interpretation finds some support in both the statute’s language, which omits the word “willfully” and instead speaks in terms of “knowing” conduct, and in the statute’s legislative history. A report prepared by Sen. Patrick Leahy explained the statute was designed to relieve the government of its burden to “prove ... willful violations of ... complex [securities] regulations [that] allow ... defendants to argue that they did not possess the requisite criminal intent.”

But there is case law supporting a contrary view. The 7th U.S. Circuit Court of Appeals has held that, in the context of the similarly worded mail, wire and bank fraud statutes, intent to defraud means “acting willfully and with specific intent to deceive or cheat, usually for the purpose of getting financial gain for one’s self or causing financial loss to another.” The 7th Circuit reached this conclusion despite the fact that these statutes, like Section 1348, do not contain the term “willfully.”

The government may opt to use Section 1348 to bring cases involving the alleged theft of honest services, which is the subject of a well-developed body of case law under the similarly worded mail and wire fraud statutes. Honest services fraud has been an attractive tool for prosecutors in recent years because the government is not required to prove that such schemes were designed to cause pecuniary or economic harm.

In Rybicki, the 2nd U.S. Circuit Court of Appeals identified two general categories of private sector honest service frauds: (1) bribery cases, where an employee accepts a secret payment in exchange for providing favored treatment in connection with their employment; and (2) self-dealing cases, where a defendant causes his or her employer to do business with a third-party entity in which the defendant has an undisclosed interest.

The risks of pursuing an honest services theory, however, were recently highlighted in U.S. v. Brown, et al., the so-called Enron Nigerian Barge case. There, the 5th Circuit rejected the government's honest services theory because the scheme, however misguided, was ultimately designed to serve the best interests of Enron. The court explained that the "Enron employees breached a fiduciary duty in pursuit of what they understood to be a corporate goal," that is, the attainment of internal earnings targets, thereby creating a situation where the "dishonest conduct [was] disassociated from bribery or self-dealing and indeed associated with and concomitant to the employer's own immediate interest."

One possible limitation to Section 1348 is that it requires evidence that the scheme is linked to securities "of an issuer with a class of securities registered under section 12 of the Securities Exchange Act of 1934 … or that is required to file reports under section 15(d) of the Securities Exchange Act of 1934." This places a wide range of schemes outside of Section 1348's reach, including most Ponzi schemes and private-placement frauds. To reach these types of schemes, prosecutors will need to continue to rely on Rule 10b-5, which is not limited to schemes involving any particular category of securities. ■

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