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Not-So-Incidental Byproducts of Kelly

By Gary Stein

Early returns are in, and they indicate that the Supreme Court's decision in *Kelly v. United States*, 140 S. Ct. 1565 (2020) — the so-called "Bridgegate" case — will be an effective tool for pruning the wild overgrowth that has built up around the federal fraud statutes.

In November, federal district judges in two separate cases dismissed wire fraud charges, finding that they ran afoul of *Kelly*'s core precept: deception does not amount to fraud unless the defendant's object was to obtain property. These decisions are notable in demonstrating that *Kelly*'s strictures apply to fraud cases generally and are not limited to the unusual factual setting of "Bridgegate."

They are also notable in highlighting the importance of a key specific holding in *Kelly*: Even if a *consequence* of the defendant's deception was to obtain property, that cannot be said to have been the defendant's *object* if it was merely an "incidental byproduct" of the scheme.

This article explores *Kelly*'s "incidental byproduct" criterion, how it has been applied by lower federal courts so far, and how it may spell the end of some of the more aggressive government fraud theories that have emerged in recent years.

Kelly

Kelly arose from an act of political retaliation against the Mayor of Fort Lee during New Jersey Governor Chris Christie's reelection campaign. Aides to the Governor, angered by the Mayor's refusal to back Christie, shut down all but one lane leading into the George Washington Bridge, creating massive gridlock on the streets of Fort Lee. To disguise their political motive, the defendants concocted a cover story, falsely claiming that the lane realignment was part of a Port Authority "traffic study."

Not content that the malefactors lost their jobs and faced possible state charges, federal prosecutors in New Jersey indicted them for wire fraud, using the bogus "traffic study" cover story as a hook. The government claimed the defendants' actions fraudulently deprived the Port Authority of two forms of property: 1) its "right to control" the physical lanes of traffic onto the George Washington Bridge; and 2) the costs of paying Port Authority engineers and toll collectors diverted to the purported traffic study. The Third Circuit affirmed the defendants' convictions.

The Supreme Court unanimously reversed. There was "no doubt," said Justice Kagan in her opinion for the Court, that the evidence showed deception and other wrongdoing. But the federal fraud statutes "do not criminalize all such conduct." Rather, the government needed to show "*property* fraud" — which required proof not only that the defendants engaged in deception, but that "an object of their dishonesty was to obtain the Port Authority's money or property."

The Court rejected both of the government's property fraud theories. First, the Court found the government's incantation of the

Gary Stein is a partner with Schulte Roth & Zabel LLP, New York, and a member of the Board of Editors of *Business Crimes Bulletin*.

magical words "right to control" insufficient to identify a property interest. In *Cleveland v. United States*, 531 U.S. 12 (2000), the Court had ruled that Louisiana's right to control who received a gaming license implicated the state's role as a regulator, not a property holder. So too the *Kelly* defendants, the Court reasoned, did not "take the lanes from the Government" but instead "regulated use of the lanes, as officials responsible for roadways so often do" — a "run-of-the-mill exercise of regulatory power [that] cannot count as the taking of property."

Second, while acknowledging that the cost of Port Authority employees' services could constitute a loss of property, the Court found that it did not satisfy the requirement that property be an "object of the fraud." In a statement of general application not limited to the facts of the case, the Court held: "[A] property fraud conviction cannot stand when the loss to the victim is only an incidental byproduct of the scheme." Applying that holding, the Court found that the Port Authority's labor costs were merely "an incidental (even if foreseen) byproduct of [the defendants'] regulatory object. Neither defendant sought to obtain the services that the employees provided." Therefore neither defendant committed property fraud.

Two aspects of *Kelly*'s "incidental byproduct" holding stand out in assessing its impact on future cases. The first is the Court's insistence that the effect on property be analyzed from the perspective of the defendant, not the victim. It was undisputed in *Kelly* that the defendants' scheme deprived the Port Authority of its property; employees were paid for services that yielded no benefit to the government. Nonetheless, the Court made clear that such an impact to the property rights of the alleged victim is insufficient, unless the defendant intentionally targets that property as the "object" of his or her scheme.

The other salient feature relates to what the government must prove about the defendant's mental state. It is not enough to show that the defendant could have foreseen, or even did foresee, that the scheme would have an impact on the alleged victim's property rights. "Even if foreseen" (in the Court's words), such an impact does not support a finding that the defendant's object was to obtain property, if it is "incidental" to the defendant's primary purpose.

Kelly in the Courts

Kelly's overall effect on the controversial "right to control" theory of property fraud, a topic adroitly covered in a prior edition of this publication, remains to be seen. *See* Robert J. Anello and Richard F. Albert, "Supreme Court Reins in Broad Reading of Fraud Statutes with 'Bridgegate' Case Ruling," *Business Crimes Bulletin* (July 2020). But the Court's unequivocal holding that the defendant must have targeted the alleged victim's property — directly, and not incidentally — is already reaping dividends.

In *United States v. Palma*, 2020 WL 6743144 (E.D. Mich. Nov. 17, 2020), the government accused a Fiat Chrysler engineer of participating in a scheme to fraudulently calibrate emissions control systems so that vehicles would satisfy federal testing requirements, yet generate higher emissions when driven by consumers. The indictment charged the engineer not only with deceiving federal regulators in violation of the Clean Air Act, but also with defrauding consumers in violation of the wire fraud statute.

Relying on *Kelly*'s "incidental byproduct" holding, the district court granted the defendant's motion to dismiss the wire fraud charges in the indictment. The defendant's job was to calibrate engines, and he had no involvement in sales. Accordingly, the court found the connection between his alleged deceit and any loss of money by Fiat Chrysler customers to be "tenuous at best" and insufficient under *Kelly*.

A week later, a federal district judge in *United States v. Ernst*, 2020 WL 6871040 (D. Mass. Nov. 23, 2020), similarly dismissed mail and wire fraud charges against four defendants indicted in the "Varsity Blues" college admissions testing scandal. The defendants, coaches and athletic directors at sports teams at various universities, allegedly took bribes to des-

ignate students as recruited athletes to facilitate their admission. They were charged not only with federal program bribery and honest services fraud, but also with property fraud.

Disagreeing with a prior Varsity Blues ruling by a different judge, *United States v. Sidoo*, 468 F. Supp. 3d 428 (D. Mass. 2020) (which barely mentioned *Kelly*), the *Ernst* court concluded that the charged object of the fraud — admission to universities — does not constitute "property" under the property fraud statutes. To the extent the government argued that a university's property rights were affected because awarding unearned degrees would decrease the value of the degrees, hurt the school's reputation and hinder its ability to collect money through donations and tuition, the court rejected the argument as "contrary to the Supreme Court's admonishment in *Kelly* that it is not enough that the scheme incidentally causes a loss of property; instead the question is whether the loss of property was the *object* of the charged fraud." The court also held that the defendants' alleged wrongful taking of the time and labor expended by the universities' staff on teaching their improperly-admitted children likewise was nothing more than an "incidental byproduct" of the charged scheme under *Kelly*.

Further Ramifications

Kelly's "incidental byproducts" holding promises to undo several other attempts by the government to stretch the federal fraud statutes beyond their proper ambit.

One example is the NCAA case, now *sub judice* before the Second Circuit in *United States v. Gatto*, No. 19-0783 (2d Cir.). In that case, employees of Adidas were charged with arranging for payments to be made in violation of NCAA rules to families of talented high-school athletes to help recruit the students to colleges. The government's "property fraud" theory is that false statements about the students' eligibility caused the schools to award them scholarships to which they were not entitled. But whether or not the charged scheme had this incidental effect, that plainly was not the defendants' object, which was to improve the college teams sponsored by Adidas (potentially increasing the value of the sponsorships). The defendants' purpose was not to obtain scholarship money for the students.

In recent years, the government has taken to bringing "bank fraud" charges where defendants allegedly made misrepresentations to induce a bank to process illegal transactions, but plainly had no intention or desire to obtain the bank's property. Pre-*Kelly*, judges in the Southern District of New York upheld such charges in part on the theory that the defendants exposed the banks to the risk of fines and civil penalties for violating OFAC or money laundering regulations. *See, e.g., United States v. Nejad*, 2019 WL 6702361, at 14-15 (S.D.N.Y. Dec. 6, 2019); *United States v. Zarrab*, 2016 WL 6820737, at 13-14 (S.D.N.Y. Oct. 17, 2016).

To the extent bank fraud is a form of federal property fraud, *see, Neder v. United States*, 527 U.S. 1, 20-21 (1999) (noting that the bank fraud statute was modeled on the mail and wire fraud statutes), it is hard to see how these decisions survive *Kelly*. No one could plausibly say that the defendants had as the "object" of their scheme a government investigation or enforcement action against the bank. Even if the defendants could foresee, or did foresee, such a result, at most it would be an "incidental byproduct" of the defendants' misrepresentations.

Conclusion

With federal prosecutors continuing to push the boundaries of the federal fraud statutes, the Supreme Court "incidental byproducts" holding has given defense lawyers a potent new doctrine with which to push back.

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Schulte Roth&Zabel

Schulte Roth & Zabel LLP
919 Third Avenue, New York, NY 10022
212.756.2000 tel | 212.593.5955 fax | www.srz.com
New York | Washington DC | London