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WHITE-COLLAR CRIME

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Calculating Loss Under the Guidelines

Prosecutors sometimes appear to vie for placement in the Guinness Book of World Records for the longest sentence in a white-collar case. They are aided by the amorphous concept of loss calculation under a sentencing guidelines structure that equates jail time with often-inflated assessments of loss caused by the crime.

In one recent case in Connecticut, the government argued for a finding of a $1.4 billion loss based on a fraudulent transaction that had no monetary impact on the earnings or revenues of the corporation in question.

In a securities law setting, loss calculation for public corporation cases can be complex, requiring the retention of experts and incorporating such abstruse concepts as leakage, corrective disclosure, event studies, and efficient markets.[1] Some courts have begun to recognize the complexity of loss calculation analyses and have attempted to temper their consequences.

Recent decisions from the U.S. Court of Appeals for the Second Circuit reflect this attitude. In *United States v. Confredo*,[2] the circuit court addressed actual versus intended loss and a defendant's right to prove his subjective intent in calculating the loss caused by his conduct. In *United States v. Rutkoske*,[3] the court dealt with loss causation and the necessity for connecting loss amounts to the defendant's wrongful conduct. Both cases assist white-collar practitioners in formulating arguments at sentencing and responding to loss calculations submitted by the government and probation department.

'United States v. Confredo'

In *Confredo*, the defendant pleaded guilty to bank fraud, false statements on loan applications, false statements to federal law enforcement officers, and witness tampering. Doing business as Granite Financial Services, Mr. Confredo coordinated the submission of over 200 fraudulent loan applications to banks located in New York City on behalf of customers who would not otherwise have been able to obtain the requested funds.

Specifically, Mr. Confredo drafted fictitious loan applications, tax returns, financial statements, and other supporting documents to create the impression that his uncreditworthy clients were well-established and profitable businesses. Granite Financial Services received a fee based on a percentage of the loan amount received by the customers. Personally, Mr. Confredo received over $2 million from the scheme.

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The Presentence Report (PSR) prepared by the Probation Department after the defendant's guilty plea calculated the loss attributable to Mr. Confredo's conduct to be $24.2 million the "total amount requested in [the] various loan applications." The PSR noted that the actual loss to the banks was "extremely difficult to ascertain due to the amount of loans involved, the continual loan payments received by the banks from the customers of the loans and the negotiations of settlement agreements between the banks and these customers."[4]

The 1997 Sentencing Guidelines applicable to Mr. Confredo's conduct provided that a sentencing court should use the greater of actual or intended loss in calculating a defendant's sentence.[5] At sentencing, the government and probation office argued that the loss calculation should be based on the intended loss attributable to Mr. Confredo's conduct, represented by the combined face value of the loan applications.

Although Mr. Confredo did not dispute the intended loss calculation, he argued that he was entitled to downward departure because the intended loss calculation overstated the true amount of loss. This was so because Mr. Confredo intended that some of the loan amounts would be repaid and, indeed, some were. Mr. Confredo argued that the actual loss caused by his scheme was in excess of $10 million, but less than $20 million. The district court agreed with the government, however, and, denied the defendant's request for a downward departure. The court sentenced Mr. Confredo to 262 months.

Mr. Confredo appealed, arguing, in part, that the court's loss calculation was erroneous. The Second Circuit remanded the case for resentencing on other grounds, but noted that the district court should revisit the loss issue on remand.[6] At the resentencing hearing, Mr. Confredo argued that the intended loss was actually between $10 million and $20 million, asserting that he did not intend a loss equaling the total face value of the loans applied for because: 1) he expected the banks to reject some of the loan applications, and 2) he believed some of his customers would pay back all or some of their loans.

The district court stated that it found Mr. Confredo's "expectation-of-repayment" point unpersuasive because the defendant "undertook no obligation himself to pay off the loans he secured." Once again, the court found that the intended loss equaled the $24.2 million face value of all the loans.

Once again, Mr. Confredo appealed. He challenged the loss calculation, arguing that because he did not expect all of the loan applications to be approved and believed portions of the loans would be repaid, that the intended loss amount was really between $10 million and $20 million. In considering Mr. Confredo's argument, the Second Circuit noted that "[a]lthough the dispute concerns only one level of enhancement, the difference between the resulting maximums of the two arguably applicable ranges is 27 months."[7]

Addressing the standard of review, the circuit court found that it was required to review the sentencing decision de novo given that the district court's rationale was based in part on an interpretation of the U.S. Sentencing Commission Guidelines finding that "a presenter of fraudulent loan application will be deemed as a matter of law to have intended a loss equal to the aggregate amount of the loans whenever the presenter is not the borrower."

Noting its history prior to 1991, the court found that the proper measure of intended loss was the total value of the loan obtained or sought, without regard to whether the defendant intended to repay the lender. This theory equated fraud to theft. Although the 1991 amendments to the guidelines preserved the general rule that a sentencing court should use intended loss amounts where they exceeded the actual loss, it recognized that types of fraud might exist where an analogy to theft would not be appropriate. In these cases, the guidelines provided that "additional factors are to be considered in determining the loss or intended loss."[8]

The 1997 amendments to the guidelines expanded on this point, specifically referencing "Fraudulent Loan Application and Contract Procurement Cases" and noting that a defendant should be given credit for "objective facts—payments prior to the discovery of fraud and assets pledged to secure the loan—that might alter a loss calculation if based solely on face amounts of loan applications."[9] The Second Circuit noted that although these amendments accounted for differences between theft offenses and fraudulent loan applications, it did not specifically provide a method for determining intended loss in cases, such as Mr. Confredo's, "where (a)

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no collateral is involved, and (b) the defendant is not a borrower but a preparer of fraudulent loan applications who claims to have expected that a number of loans would be denied and at least some portion of the loans granted would be repaid."[10]

Turning to an analysis of case law, the court noted that in *United States v. Brach,* it had upheld the use of the face value of a fraudulently obtained loan as the loss amount where the defendant, who was also the borrower, had in fact repaid the entire loan and had intended to repay it when he submitted the fraudulent loan application.[11] This holding was consistent with the 1991 version of the guidelines which equated fraud with theft, and allowed the circuit court to conclude that "probable loss" meant the potential loss that the defendant's conduct could have caused.

The Second Circuit's decision in *Brach* was rejected by several courts, however, including the Third Circuit in *United States v. Kopp.*[12] In *Kopp,* the Third Circuit disagreed with the Second Circuit's analysis, siding instead with the Seventh Circuit in finding that it was "'simple' but 'irrational' to treat all frauds as equivalent to thefts." Instead, the sister circuits preferred an approach that considered whether the defendant actually intended to pocket the face value of the amount he had fraudulently procured. The Court noted that since *Kopp,* the Third Circuit has consistently held that "[i]ntended loss refers to the defendant's subjective expectation, not to the risk of loss to which he may have exposed his victims."[13]

Accordingly, the court concluded that given the amendments to the sentencing guidelines and the persuasive case law from its sister circuits, that in calculating intended loss in cases such as Mr. Confredo's, "the defendant should have an opportunity to persuade the sentencing judge that the loss he intended was less than the face amount of the loans." If the defendant's expectations of repayment or rejection were not manifested, the defendant would be subject to punishment for the higher actual loss amount.[14]

Pursuant to this holding, the Second Circuit again remanded Mr. Confredo's case to allow the district court to reconsider the extent, if any, to which Mr. Confredo had proved a subjective intent to cause a loss of less than the aggregate amount of the loans. If so, the applicable loss calculation should reflect only the intended loss amount.

'United States v. Rutkoske'

In *Rutkoske,* the Second Circuit discussed the factors a sentencing court is required to consider when calculating the amount of loss attributable to securities fraud claims. Focusing less on the defendant's intent, as in *Confredo*, the court looked at external factors that cause losses in securities fraud cases and how these amounts should be separated from any amount for which the defendant is held liable. Mr. Rutkoske was convicted of securities fraud and conspiracy to commit securities fraud, commercial bribery, and wire fraud in the U.S. District Court for the Southern District of New York. At sentencing, the district court adopted the probation department's recommendation that the defendant's base offense level be increased by 15 levels for a monetary loss of more than $10 million. In so finding, the court rejected the defendant's objections with respect to the loss calculations, sentencing Mr. Rutkoske to 108 months in prison. Mr. Rutkoske appealed.

Mr. Rutkoske owned a brokerage firm that sold stock to retail customers and provided investment banking services to institutional clients. In 1997, Mr. Rutkoske permitted certain of the firm's employees to enter into an investment banking agreement with NetBet, a start-up Internet gambling company. Pursuant to the agreement, with Mr. Rutkoske's knowledge, his employees sold NetBet stock to customers using "boiler room tactics" and without disclosing or lying about the commissions earned by brokers on the sales. In addition, the firm frequently would create a market in NetBet stock by buying the stock from other firms in order to increase the price of the stock sold to its customers.

From January 1997 to April 1999, Mr. Rutkoske's firm accounted for 72 percent of retail sales of NetBet stock; from July to December 1997, it accounted for 90 percent of the trading volume. Eventually, the price of NetBet shares plummeted and investors lost more than $12 million.

In determining the loss amount, the district court relied on the government expert's conclusion that the loss associated with Mr. Rutkoske's securities fraud was over $12 million. The expert arrived at this amount by calculating customer losses on NetBet stock purchases and sales between January 1997 and July 29, 1999, the last date for which the parties had pricing information forms from market makers trading NetBet stock. Analyzing the district court's calculation, the Second Circuit noted that the method "implicitly attributed the total amount of the decline in the value of NetBet shares to [Mr.] Rutkoske's offense conduct."[15]

Citing its decision in *United States v. Ebbers,* the circuit court noted that the process of calculating loss amounts in criminal stock fraud cases is inherently complex, but noted that "[t]he loss must be the result of the fraud."[16] Accordingly, losses which resulted from something other than the convicted fraudulent activity "must be excluded from the loss calculation."

In *Ebbers,* the Second Circuit cited approvingly the Fifth Circuit's decision in *United States v. Olis.*[17] In *Olis,* the Fifth Circuit looked to the calculation of damages in civil securities fraud cases for guidance in calculating loss amounts under the guidelines in criminal securities fraud cases. In so doing, the Fifth Circuit relied upon the Supreme Court's decision in *Dura Pharmaceuticals Inc. v. Broudo* which "observed that although an artificially inflated price might cause an investor's loss when the investor sells his shares 'after the truth makes its way into the marketplace,' other factors, such as changed economic conditions, might also contribute to a stock's decline in price, and a plaintiff must prove that the misrepresentation proximately caused the economic loss."[18]

The Second Circuit in *Rutkoske* said that the principles set forth by the Supreme Court in *Dura Pharmaceuticals*, similarly were applicable to the criminal case before it. The government opposed this notion. Referring to dicta in its decision in *Ebbers,* the Second Circuit stated "we see no reason why considerations relevant to loss causation in a civil fraud case should not apply, at least as strongly, to a sentencing regime in which the amount of loss caused by a fraud is a critical determinant of the length of a defendant's sentence."

Turning to the facts of Mr. Rutkoske's conduct, the government argued that whatever obligations imposed by *Dura Pharmaceuticals, Ebbers,* and *Olis* had been satisfied. The court disagreed that evidence that NetBet shares traded in a "thin" market and that the price of the stock plummeted after Mr. Rutkoske's scheme unraveled was sufficient to attribute all market losses to Mr. Rutkoske. "[A] 'thin' market does not preclude the effect of market forces, although it may minimize them. The Government provides no record citation to any particular date to support its generalized claim that the scheme 'unraveled.'"[19] Concluding that the district court's failure to consider other factors relevant to a decline in NetBet stock was erroneous in calculating the loss attributable to Mr. Rutkoske's conduct, the court remanded the case for resentencing.[20]

Conclusion

Loss calculation often artificially inflates the guidelines to unrealistic proportions. Even as a starting point, a white-collar guideline calculation of life or greater (a sentence best left for murderers), although absurd, casts a heavy pall on the §3553(a) concepts which are more appropriate sentencing criteria.

1. *Lentell v. Merrill Lynch & Co.,* 396 F.3d 161 (2d Cir.), cert. denied, 546 U.S. 935 (2005); *Liu v. Credit Suisse First Boston Corp.,* 383 F. Supp. 566, 579 (S.D.N.Y. 2005); see generally, Thornsen, Kaplan and Hakala, "Rediscovering the Economics of Loss Causation," 6 Journal of Business & Securities Law 93 (2006).
2. 528 F.3d 143 (2d Cir. 2008).
3. 506 F.3d 170 (2d Cir. 2007).
4. Id. at 146.
5. U.S.S.G. §2F1.1 (1997).
6. 528 F.3d at 147-148. The Circuit Court noted that although Mr. Confredo did not object to the loss calculation during sentencing, the loss amount issue had been raised in connection with his downward departure motion and had not, therefore, been waived.
7. Id. at 149.
8. Id. at 150 (citing U.S.S.G. §2F1.1, comment (n.7) (1991)).
9. U.S.S.G. §2F1.1, comment. (n.7(b)) (1997).
10. 528 F.3d at 151.
11. 942 F.2d 141 (2d Cir. 1991).
12. 951 F.2d 521 (3d Cir. 1991).
13. 528 F.3d at 152.
14. Id.
15. Id. at 178.
16. 458 F.3d 110, 128 (2d Cir. 2006).
17. 429 F.3d 540 (5th Cir. 2005).
18. *Rutkoske*, 506 F.3d at 179 (citing *Dura Pharmaceuticals*, 544 U.S. 336 (2005)).
19. Id. at 180.
20. The court also noted that in some cases the total loss may be so massive, that the loss enhancement will remain the same regardless of whether a district court considers other causes of price decline. In these types of cases, such as *Ebbers,* the court said that remand was unnecessary. Id. at 179.