New York Law Journal

SERVING THE BENCH AND BAR SINCE 1888

WWW.NYLJ.COM

An incisivemedia publication

VOLUME 242—NO. 44

TUESDAY, SEPTEMBER 1, 2009

WHITE-COLLAR CRIME

Expert Analysis

Loss Calculation in Sentencing For Securities Fraud Cases

By **Elkan Abramowitz**

And **Barry A. Bohrer**

White-collar practitioners and corporate lawyers should take note of a significant and evolving trend in loss calculations for securities fraud crimes under the U.S. Sentencing Guidelines. A defendant convicted of an economic crime may have the calculation of his advisory sentencing range increased under Section 2B1.1 of the sentencing guidelines depending on the amount of loss caused by the offense. However, a defendant is to be held liable only for those losses caused directly by the wrongful conduct for which he was convicted.

The guidelines provide that a sentencing court need only make a reasonable estimate of this loss amount "given the available information."[1] Reviewing appellate courts must determine whether the method of calculating such loss is "legally acceptable."

Especially in the highly sophisticated and complex realm of securities law, calculating loss can be difficult. Recently, federal circuit courts have looked to, and in some instances adopted, the loss calculations methodologies employed in the civil context to determine the validity of a district court's loss calculation in the criminal context.

Securities Fraud

In *United States v. Olis*,[2] the U.S. Court of Appeals for the Fifth Circuit reviewed the defendant's sentence of 292 months imprisonment for securities fraud, mail and wire fraud, and conspiracy. Jamie Olis was a senior tax lawyer and accountant at Dynegy Corporation involved in a complex five-year deal involving natural gas transactions. At trial, the government proved that Mr. Olis and others intentionally concealed information about the deal from Dynegy's auditors which resulted in fraudulent accounting practices and the reporting of false statements to the SEC.

These cases signal an important change in sentencing law in securities fraud cases.

In calculating Mr. Olis' sentence under Section 2B1.1, the district court added 26 levels to Mr. Olis' base offense level finding that the fraudulent scheme caused a loss of $105 million to one shareholder. Mr. Olis appealed, arguing in part that the district court overstated the loss in calculating his sentence. The Fifth Circuit noted a district court's obligation to "take a reasonable economic approach to determine what losses the defendant truly caused or intended to cause," and observed that principles applied in calculating civil damages in securities fraud cases provided useful guidance. Indeed, the court noted that although the loss guideline is "skeletal" because it covers a range of federal property crimes, well-established principles of loss causation in civil cases allowed sentencing courts to add "some flesh" to the bones.[3]

These principles were articulated in the Supreme Court's decision in *Dura Pharmaceuticals Inc. v. Broudo*.[4] In that case, the Court rejected the U.S. Court of Appeals for the Ninth Circuit's holding that plaintiffs in a civil stock fraud case could establish loss causation simply by showing that the purchase price was inflated because of the defendants' misrepresentation. While an artificially inflated price might cause an investor's loss upon the sale of his shares after the disclosure of the misrepresentation, the Court noted that 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."

As characterized by the Fifth Circuit, "there is no loss attributable to a misrepresentation unless and until the truth is subsequently revealed and the price of the stock accordingly declines. Where the value

ELKAN ABRAMOWITZ *is a member of Morvillo, Abramowitz, Grand, Iason, Anello & Bohrer. He is a former chief of the criminal division in the U.S. Attorney's Office for the Southern District of New York.* BARRY A. BOHRER *is also a member of Morvillo, Abramowitz and was formerly chief appellate attorney and chief of the major crimes unit in the U.S. Attorney's Office for the Southern District of New York.* GRETCHAN R. OHLIG, *an attorney, assisted in the preparation of this article.*

of a security declines for other reasons, however, such decline, or component of the decline, is not a 'loss' attributable to the misrepresentation." Thus, in calculating the loss attributable to a criminal defendant for sentencing purposes in a securities fraud case, the portion of a price decline caused by other factors must be excluded.[5] In Mr. Olis' case, the district court failed to take into account the impact of extrinsic factors on the decline in Dynegy's stock price. Accordingly, the Court of Appeals concluded that Mr. Olis was entitled to a resentencing.

The U.S. Court of Appeals for the Second Circuit reached a similar conclusion in *United States v. Rutkoske*.[6] David Rutkoske was convicted of securities fraud and conspiracy to commit securities fraud. In calculating loss under the guidelines, the district court attributed the total amount of the decline in the stock's price to Mr. Rutkoske's wrongful conduct. In reviewing the sentence, the Second Circuit noted that in its prior decision in *United States v. Ebbers*,[7] "we acknowledged the complexities inherent in calculating the loss amount but emphasized that '[t]he loss must be the result of the fraud'" and that losses sustained by other causes must be excluded from the loss calculations under the guidelines.

Favorably citing the Fifth Circuit's decision in *Olis*, the Second Circuit opined that considerations relevant to loss causation in civil fraud cases should 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." The government argued that because the shares manipulated by Mr. Rutkoske were traded in a "thin market, any obligations under *Dura, Ebbers* and *Olis* were satisfied. The Court of Appeals rejected this idea, however, finding that while the low volume of trading may have minimized the effects of market forces, it did not preclude them. "The District Court's basic failure to at least approximate the amount of the loss caused by the fraud without even considering other factors relevant to the decline in [] share price requires a remand to redetermine the amount of the loss."[8]

Although these decisions instruct sentencing courts to adopt principles applied to civil loss causation determinations, this does not mean that the civil fraud standard "necessarily and always" applies. Rather, "sentencing courts must calculate guidelines loss against the backdrop of an efficient market, and must account for confounding factors that may also have affected a company's stock price."[9]

'United States v. Nacchio'

This past July, in *United States v. Nacchio,* the U.S. Court of Appeals for the Tenth Circuit similarly advocated relying on cases from the civil sphere in calculating a defendant's criminal sentence. Joseph Nacchio was the CEO of Qwest Communications International Inc. and was convicted on nineteen counts of insider trading based on his personal sale of Qwest stock. He appealed the district court's sentence, arguing that it had improperly calculated the gain attributable to him as a result of the alleged wrongful conduct.

Section 2F1.2 of the guidelines, which then applied to insider trading offenses and authorized a court to increase the base offense level of 9 according to "the gain resulting from the offense."[10] The sentencing calculations in insider trading cases differ from other securities fraud cases "because the victims and their losses are difficult if not impossible to identify." Accordingly, courts are instructed to determine the defendant's gain—the total increase in value realized through trading in securities—instead of the victims' losses.[11]

The government argued that Mr. Nacchio's gain was the net profit received from his stock sales. Mr. Nacchio disagreed with this approach, however, submitting an expert report that analyzed how the ultimate disclosure of the alleged insider information impacted stock prices. The report concluded that only two such disclosures were statistically significant. The district court declined to employ either the government or Mr. Nacchio's approach. Instead, the district court calculated Mr. Nacchio's gain by subtracting the purchase costs and taxes withheld from Mr. Nacchio's gross proceeds.

The Tenth Circuit rejected the district court's analysis of the defendant's gain and held that the manner in which it is calculated should be "more narrowly focused on producing a figure that reflects, in at least approximate terms, the proceeds related to his criminally culpable conduct (i.e., trading on material, non-public information)."

In reaching this conclusion, the court reviewed a divided en banc decision from the U.S. Court of Appeals for the Eighth Circuit, *United States v. Mooney*.[12] In that case, the majority rejected the sentencing court's use of a "market absorption" approach in determining the defendant's gain under the insider trading guideline, the same as applied by the SEC in civil cases seeking disgorgement.

However, the Tenth Circuit agreed with the dissenting opinion in the decision, which focused on the guideline phrase "gain resulting from the offense," stating that the offense of insider trading "is not the purchase of the stock itself, but the use of a manipulative or deceptive contrivance in connection with the purchase. The offense inheres not in the purchase itself, but in any deception that may be entwined with the purchase."[13]

In adopting a realistic, economic approach to calculating gain for purposes of sentencing those convicted of insider trading, the Tenth Circuit opined that the sentencing court was required to recognize that the offense is not the purchase, but the deception—"gain resulting from the offense" is not gain resulting from the purchase of stock, but gain resulting from the deception employed in the stock transaction.

Like those cases discussing loss calculation with respect to sentencing defendants convicted of securities fraud, the court relied on the Supreme Court's decision in *Dura Pharmaceuticals* and the Fifth Circuit's opinion in *Olis* to find that a district court was required to consider the myriad of factors unrelated to criminal fraud that could have contributed to the value of the securities.[14] The Tenth Circuit noted that although a net-profit approach would result in more certain outcomes, the approach advocated by the *Olis* court achieved the "critical objective of federal sentencing [that] the imposition of punishment on the defendant... reflect[] his or her culpability for the criminal offense (rather than for the unrelated gyrations of the market)."

"Mr. Nacchio's increased prison sentence should be linked to the gain actually resulting from the offense, not gain attributable to legitimate price appreciation and the underlying value of the Qwest shares." Because there was no indication that Nacchio's deception rendered Qwest's stock worthless, the district court's calculation was erroneous.

A proper computation, in the court's opinion, would look to civil jurisprudence, specifically the SEC's disgorgement remedy. The civil disgorgement remedy applied by the SEC in insider trading enforcement cases is "generally the difference between the value of the shares when the insider sold them while in possession of the material, non-public information, and their market value 'a reasonable time after public dissemination of the inside information.'"[15]

The court looked to the SEC's disgorgement remedy rather than a civil loss analysis, noting that the latter was inappropriate in an insider trading case which calculates gain rather than loss. "Because it seeks to strip the wrongdoer of illgotten gains and deter improper conduct, disgorgement provides an appropriate, close-fitting civil analogue."[16] Notwithstanding the conflict between the decisions of the Tenth and Eighth circuits in *Nacchio* and *Mooney*, the Department of Justice has indicated that it would not be seeking further review of the *Nacchio* case in the Supreme Court.

Conclusion

These cases signal an important change in sentencing law in securities fraud cases, where criminal loss (or gain) analysis under the guidelines more closely resembles the similar calculations from civil law and incorporates a proximate cause analysis. Commentators express some concern with an increase in the "level of economic and mathematical skills needed by counsel and the courts to handle these cases."[17] In all likelihood, practitioners increasingly will rely on experts to calculate loss calculations and explain extrinsic factors, beyond the defendant's wrongful conduct, that may have affected a stock's price.

1. U.S.S.G. §2F1.1 cmt. n. 9.
2. 429 F.3d 540 (5th Cir. 2005).
3. Id. at 546.
4. 544 U.S. 336 (2005).
5. 429 F.3d at 546-47.
6. 506 F.3d 170 (2d Cir. 2007).
7. 458 F.3d 110, 128 (2d Cir. 2006). Although the district court's loss calculation was flawed because it did not consider factors other than the offense conduct that impacted upon the stock's price, the Second Circuit found that any such consideration would still have resulted in a massive loss—well over the $100 million maximum enhancement under the guidelines—that a remand was unnecessary.
8. 506 F.3d 180.
9. *United States v. Ferguson*, 584 F. Supp.2d 447, 452 (D. Conn. 2008).
10. 2009 WL 2343716 (10th Cir. July 31, 2009). *Nacchio* addresses an earlier version of the guidelines that is no longer in effect. At the time of Mr. Nacchio's offense, Section 2F1.1 was used to assess sentences in insider trading cases. In the Nov. 1, 2001 version of the guidelines, however, Section 2F1.1 was consolidated with 2B1.1, and a separate Section, 2B1.4, was enacted for insider trading cases. Unlike other fraud cases, in both versions of the guidelines the insider trading provision specifically states that the gain from the offense, not the loss, is used to enhance a defendant's sentence under the fraud loss table that is now located in Section 2B1.1(b). Regardless, despite the fact that *Nacchio* addresses gain under the guidelines, rather than loss, the court's underlying holding—that a sentencing enhancement based upon the fraud loss table must be causally linked to the defendant's offense conduct—still applies more broadly to all fraud cases for which this table is used to increase the defendant's advisory guidelines level.
11. U.S.S.G. §2F1.2 cmt. background.
12. 425 F.3d 1093 (8th Cir. 2005).
13. Id. at 1106 (Bright, J., dissenting).
14. 2009 WL 2343716, 13.
15. *SEC v. Happ,* 392 F.3d 12, 31 (1st Cir. 2004) (quoting *SEC v. MacDonald*, 699 F.2d 47, 55 (1st Cir. 1983) (en banc)).
16. 2009 WL 2343716, 15.
17. Ellen S. Podgor, "Commentary on *Nacchio*," White Collar Crime Prof Blog (July 31, 2009) (available at: http://lawprofessors.typepad.com/whitecollarcrime_blog/2009/07/ commentary-on-nacchio.html).