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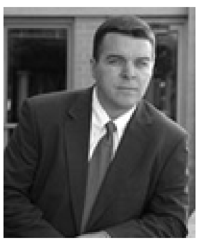
Is Civil Loss Causation Applicable to Federal Criminal Sentencings?



BY THOMAS HANUSIK AND REBECCA BADEN

The Supreme Court's 2005 decision in *Dura Pharmaceuticals, Inc. v. Broudo* is the seminal authority on the appropriate measure of loss caused by a defendant's fraudulent conduct in a civil securities fraud action. Under the *Dura* standard, a plaintiff must provide actual evidence that the defendant's conduct proximately caused the plaintiff's losses. The *Dura* standard thus requires ''loss causation.'' Less clear is whether this same standard should drive a federal sentencing court's determination of actual losses when calculating a defendant's sentence under the federal guidelines. The Fifth and Second Circuits have held that *Dura*'s ''loss causation'' standard applies to federal sentencing for securities fraud cases, but the Ninth Circuit has refused to adopt this same approach and a circuit split has developed as a result.

Loss Causation under Dura Pharmaceuticals

In 2005, a unanimous Supreme Court decided *Dura Pharmaceuticals, Inc. v. Broudo*, an important decision with significant ramifications for ''fraud-on-the-market'' private securities litigations.[1] The *Dura* Court held that a private plaintiff claiming to be the victim of a ''fraud-on-the-market'' scheme must both plead and prove that the defendant's fraud proximately caused her to suffer economic loss.[2] In so holding, the *Dura* Court overruled the Ninth Circuit, which had found that a stock's inflated purchase price sufficiently proved the plaintiff's economic loss.[3] In rejecting the Ninth Circuit's analysis, the *Dura* Court emphasized that any plaintiff alleging securities fraud must establish traditional notions of proximate causation, and that an inflated purchase price alone is not enough to make that showing.[4]

The *Dura* Court identified three distinct rationales for rejecting the notion that an inflated purchase price alone could establish the requisite proximate loss causation. *First*, the Court relied on what it referred to as ''pure logic.''[5] *Second*, the Court considered the similarities between securities litigation and common law misrepresentation claims, and analogized their respec-

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[1] 544 U.S. 336 (2005). The ''fraud on the market'' theory holds that the price of a company's stock is determined by available information; thus, misleading statements defraud investors even if investors do not rely on those statements. *Basic Inc. v. Levinson*, 485 U.S. 224, 241-42 (1988).

[2] *Id.* at 346.

[3] *Id.*

[4] *Id.*

[5] *Id.* at 342-43.

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tive proximate cause analyses.[6] *Third*, the Court found that Congress' intent in enacting the Private Securities Litigation Reform Act of 1995 militated against the Ninth Circuit's interpretation of loss.[7]

First, the Court reasoned that ''as a matter of pure logic'' an inflated purchase price does not prove ''loss causation.''[8] Under this analysis, at the moment a plaintiff purchases a stock – even an overvalued stock – the ownership value is *equal to* the purchase price and at that very moment, the plaintiff has suffered no loss.[9] If the purchaser then sells the offending security before the misrepresentation is publicly revealed, that misrepresentation will not have proximately caused any loss to the plaintiff.[10] Even if a plaintiff sells a security after a misrepresentation has been publicly revealed, the purported ''loss'' may reflect other variables – such as changed economic circumstances; changed investor expectations; or the discovery of new, relevant facts, conditions or events.[11] According to the Court's reasoning, only *sometimes* will an inflated purchase price proximately cause a future loss.[12] And *sometimes* satisfying the proximate causation element is insufficient to *always* establish proximate causation as a matter of law.[13]

Second, according to the *Dura* Court, securities fraud actions have common law roots. And, at common law, a successful plaintiff in a misrepresentation action[14] must prove that a defendant's conduct caused her to suffer actual loss.[15] Because an inflated purchase price neither demonstrates that a plaintiff has suffered actual loss, nor that any potential loss was caused by the defendant's conduct, it is insufficient to support an action for fraud.[16] To allow a ''fraud-on-the-market'' claim to proceed based on allegations that do nothing more than identify an inflated purchase price would violate this basic tenet of common law.[17]

Third, the statute enabling plaintiffs to bring claims based on a ''fraud-on-the-market'' theory evidences Congress' intent to provide for a recovery only where a plaintiff demonstrates that the defendant's conduct proximately caused her to suffer an actual loss.[18] When enacting the Private Securities Litigation Reform Act of 1995, the Court found that Congress ''expressly impose[d] on plaintiffs the burden of proving that the defendant's misrepresentations caused the loss for which the plaintiff seeks to recover.''[19] ''By way of contrast, the Ninth Circuit's approach would allow recovery where a misrepresentation leads to an inflated purchase price but nonetheless does not proximately cause any economic loss.''[20] Having found that proximate cause was a requirement, the Court rejected the Ninth Circuit's approach.

Does Dura Apply to Federal Sentencings? Should It?

The *Dura* opinion has become a pillar in nearly every case involving ''fraud-on-the-market'' private securities litigation. Courts, however, are less aligned about whether the *Dura* Court's requisite proximate cause – ''loss causation'' – analysis should apply during federal sentencing determinations under the advisory guidelines. Simply put, the circuits are split as to whether a sentencing court must determine the specific amount of loss caused by a defendant's conduct. To date, of the three circuits that have opined on this issue, only the Ninth Circuit questions the propriety of applying a ''loss causation'' analysis to determine an appropriate sentence for a federal securities fraud conviction.

The Guidelines

The United States Sentencing Guidelines (''Guidelines'') are a set of advisory standards used to determine sentences for offenders convicted of federal crimes.[21] The Guidelines aim to establish uniform sentencing standards and to create an effective and fair sentencing system.[22] The Guidelines advise courts on how to sentence defendants convicted of a variety of offenses, including offenses involving fraud.[23] According to the Guidelines, the appropriate sentence for a fraud offense should correspond to the amount of loss caused by that offense.[24] More specifically, an individual convicted of a fraud offense is subjected to a gradually enhanced sentence based on the ''greater of actual loss[25] or intended loss'' caused to his victims.[26] Because of the difficulty involved in precisely calculating the amount of loss caused by an offense, the Guidelines provide that a sentencing ''court need only make a reasonable estimate of the loss.''[27] To estimate this loss, the Guidelines suggest that courts take into account an illustrative list of factors that include the reduction in value of securities assets caused by the offense.[28]

The question facing sentencing courts in applying the Guidelines is whether this guidance weighs in favor of, or against, applying the *Dura* loss causation analysis.

Fifth Circuit

In *United States v. Olis*, the Fifth Circuit became the first court to consider whether the *Dura* ''loss causa-

[6] *Id.* at 343-44.
[7] *Id.* at 345-46.
[8] *Id.* at 342-43.
[9] *Id.*
[10] *Id.*
[11] *Id.*
[12] *Id.*
[13] *Id.*
[14] At common law, an individual who ''fraudulently makes a misrepresentation of fact, opinion, intention or law for the purpose of inducing another to act or to refrain from action in reliance upon it, is subject to liability'' for losses caused by the justifiable reliance. Restatement (Second) of Torts § 525.
[15] *Id.* at 343-44.
[16] *Id.*
[17] *Id.*
[18] *Id.* at 345-46.
[19] *Id.* at 345 (internal citation omitted).
[20] *Id.* at 346.
[21] United States Sentencing Commission, *Guidelines Manual*, Ch. 1, Pt. A, intro.
[22] *Id.*
[23] USSG § 2B1.1.
[24] *Id.*
[25] The Guidelines define ''actual loss'' as the ''reasonably foreseeable pecuniary harm that resulted from the offense.'' USSG § 2B1.1 cmt. 3(A). Reasonably foreseeable pecuniary harm is itself defined as harm that can be readily measurable, and that the ''defendant knew or, under the circumstances, reasonably should have known, was a potential result of the offense.'' *Id.* at § 2B1.1 cmt. 3(A)(i)-(iv).
[26] *Id.* at cmt. 3(A).
[27] *Id.* at 2B1.1 cmt. 3(C). When actual loss ''reasonably cannot be determined,'' a court shall measure the loss by the gain that resulted from the offense. *Id.* at 2B1.1 cmt. 3(B).
[28] *Id.* at 2B1.1 cmt. 3(C)(v).

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tion'' standard should guide a federal sentencing analysis, and the first to find that it should.[29] The *Olis* case arose out of a ''fraud-on-the-market'' scheme under which officials at Dynegy, Corp. – a publicly traded company – defrauded investors into believing that the company's operations generated $300 million in revenue that were in fact borrowed funds.[30] Defendant Olis, the Senior Director of Tax Planning and International at Dynegy was, among other things, convicted of securities fraud for his role in the scheme.[31] After Olis' conviction, the trial court applied Guidelines Section 2B1.1 to determine the amount of loss that would guide his sentence.[32] In doing so, the sentencing court enhanced Olis' sentence, finding that Olis' fraudulent conduct caused $105 million in losses to one particular shareholder.[33]

Olis appealed his sentence, complaining in part that the sentencing court improperly calculated the amount of loss his offense caused.[34] The Fifth Circuit agreed with Olis on the grounds that the sentencing court improperly relied solely on testimony about the decrease in purchase price of Dynegy's stock to determine the loss that Olis' conduct caused.[35] The court reasoned that in calculating a defendant's sentence, it is important to assess only those losses that a defendant himself truly *caused* to the victim.[36] A court cannot punish a defendant for loss that could have been caused by extrinsic forces.[37] In reaching its conclusion, the Fifth Circuit noted that ''[u]seful guidance appears in the applicable principles for recovery of civil damages for securities fraud.''[38] Citing *Dura Pharmaceuticals v. Broudo*, the *Olis* Court continued that ''[t]he civil damage measure should be the backdrop for criminal responsibility because it furnishes the standard of compensable injury for securities fraud victims and because it is attuned to stock market complexities.'' *Id.* In sum, the *Olis* Court found that the *Dura* ''loss causation'' analysis is an important component of a loss calculation under the federal sentencing guidelines.

Under the facts before it, the Fifth Circuit found that Olis' conduct could not support the sentence imposed.[39] In determining how much loss Olis' conduct caused, the district court did not evaluate the potential effects of external factors, nor the fact that Dynegy's stock price went down before Olis' fraud was publicly revealed.[40] The case was therefore reversed and remanded for a new sentencing.

Second Circuit

Two years later, the Second Circuit followed the *Olis* Court's lead by ''look[ing] to principles governing recovery of damages in civil securities fraud cases for guidance in calculating the loss amount for a Guidelines enhancement.''[41] In *United States v. Rutkoske*, the owner of a small brokerage firm called Lloyd Wade Securities, David Rutkoske, was convicted of securities fraud for manipulating the stock price of a start-up Internet gaming company called NetBet.[42] Rutkoske paid brokers large, undisclosed commissions for selling NetBet stock. This led brokers to pressure customers to buy NetBet stock, and to purchase the stock over their objections. The same brokers also avoided investors seeking to sell NetBet stock and refused to place sell orders.[43] Ultimately, the inflated price of NetBet shares plunged, causing investors to lose more than $12 million.[44]

In sentencing Rutkoske for his securities fraud conviction, the United States District Court for the Southern District of New York attributed the entire $12 million loss to Rutkoske's conduct.[45] According to the Second Circuit, this finding constituted reversible error because the District Court did not even attempt to approximate the amount of loss caused by Rutkoske's fraud, nor to consider other factors relevant to the decline in NetBet's share price.[46] The *Rutkoske* Court found the District Court's decision inimical both to Second Circuit precedent and to the federal sentencing guidelines.[47]

To support its conclusion, the *Rutkoske* Court looked directly to the Fifth Circuit's decision in *Olis*, and the *Olis* Court's reliance on *Dura*'s loss causation analysis.[48] Like the Fifth Circuit, the *Rutkoske* Court considered the *Dura* analysis to be ''useful guidance'' in criminal sentencing for securities fraud convictions.[49] The Second Circuit further supported its position by citing the Guidelines' emphasis that the amount of loss caused by a defendant is a critical component in establishing a sentence for fraud offenses.[50]

District Court of Connecticut

In 2008, the District Court of Connecticut followed the Second Circuit's guidance for calculating loss.[51] In *United States v. Ferguson*, several defendants were convicted of securities fraud and other various crimes, resulting from their participation in a fraudulent loss portfolio transfer reinsurance transaction.[52] In determining the appropriate sentence to apply, the District Court evaluated different analyses presented by the parties, each alleging various loss amounts caused by the defendants' conduct.[53] The Court first rejected the government's proffered loss amount, which was based

[29] 429 F.3d 540 (5th Cir. 2005).
[30] *Id.* at 541.
[31] *Id.*
[32] *Id.* at 545.
[33] *Id.* at 542.
[34] *Id.* at 543.
[35] *Id.* at 548.
[36] *Id.*
[37] *Id.* at 549.
[38] *Id.* at 546.
[39] *Id.* at 548-49.
[40] *Id.*

[41] *U.S. v. Rutkoske*, 506 F.3d 170, 179 (2d Cir. 2007) (citing *Olis*, 429 F.3d at 546).
[42] *Id.* at 171.
[43] *Id.* at 173.
[44] *Id.*
[45] *Id.* at 178. In sentencing *Rutkoske*, the District Court applied Guidelines Section 2F1.1, the precursor to current Section 2B1.1.
[46] *Id.* at 180.
[47] *Id.* at 179; *See United States v. Ebbers*, 458 F.3d 110 (2d Cir. 2006) (a criminal stock fraud case holding that a loss amount must be only that loss which was the result of a fraud).
[48] *Id.* at 179.
[49] *Id.*
[50] *Id.*
[51] *United States v. Ferguson*, 584 F. Supp. 2d 447 (D. Conn. 2008), *vacated on other grounds*, 653 F.3d 61 (2d Cir. 2011).
[52] *Id.* at 448.
[53] *Id.* at 449-50.

on the findings of a leakage event study.[54] Such a study takes account of several days during a relevant period of time which individually may be statistically insignificant, but when considered together, have statistical significance.[55] The Court instead adopted the defendants' proposed loss analysis, whereby loss was calculated by examining the relationship between public news about a company and subsequent stock price movement.[56]

Although primarily drawing its support from the *Rutkoske* and *Olis* decisions to determine the appropriate sentencing standard, the District Court here was slightly more reserved than were those courts in applying a civil loss causation standard in the criminal sentencing context.[57] In particular, the court found that it need only ''adopt from the civil context the 'considerations relevant' to civil loss causation, not necessarily and always the civil fraud standard.''[58] That said, the District Court conceded that a sentencing court ''must calculate loss against the backdrop of an efficient market, and must account for confounding factors that may have also affected a company's stock price.''[59]

Ninth Circuit

Despite the previously consistent application of the *Dura* loss causation analysis to criminal sentencing, in *United States v. Berger*, the Ninth Circuit effectively created a circuit split when it declined to follow the approach of the Fifth and Second Circuits.[60] In *Berger*, the defendants were executives of Craig Consumer Electronics, Inc., a publicly traded consumer electronics business, that relied on a revolving credit agreement for funding.[61] The credit agreement required defendant Berger to certify daily that the business held sufficient assets to justify the line of credit.[62] Shortly after entering into the credit agreement, Berger began falsifying the daily certifications.[63] Berger, and others, were convicted for that conduct.[64] In determining the defendants' sentences, the District Court applied a ''modified market capitalization theory.''[65] Under this theory, the Court looked at the average depreciation of stock value in unaffiliated companies after accounting irregularities were uncovered at those companies.[66] The Court then applied that average amount of depreciation to Craig Consumer Electronics' stock to establish the amount of loss caused by the defendants' conduct.[67]

On appeal, the Ninth Circuit found that the District Court used an inappropriate method of calculating loss, but nevertheless refused to apply the *Dura* standard, as urged by the defendants.[68] The Court rested its analysis on two primary rationales: (1) inherent distinctions between civil and criminal cases render the *Dura* standard inapplicable to criminal sentencing; and (2) the *Dura* analysis conflicts with – rather than supports – the Guidelines.[69]

First, the *Berger* Court specifically rejected the notion that overvaluation of a stock cannot be a valid measure of loss causation in a criminal context.[70] Whereas loss in the civil context is measured by the amount of loss to an individual, criminal loss is determined by loss to society as a whole.[71] Thus, even though the amount of loss caused to any one person or group may not be readily ascertained by the overvaluation of stock, loss to society is apparent when fraud induces the overvaluation of a stock.[72]

Second, unlike the *Olis* and *Rutkoske* Courts, which found that the Guidelines supported the *Dura* standard's application in federal sentencing, the *Berger* Court found that the Guidelines cut against such an application.[73] In large part, the *Berger* Court supported its position by citing a Guidelines section and comment that have long since been deleted.[74] In extrapolating on what constitutes a fraud, the deleted comment explained that a fraudulent misrepresentation exists ''[w]here, for example, a defendant fraudulently represents that stock is worth $40,000 and the stock is worth only $10,000, the loss is the amount by which the stock was overvalued (i.e., $30,000).''[75] The Court thus found that a decrease in a stock's purchase price can be attributed to a defendant's fraudulent conduct for sentencing purposes.

Conclusion

The Supreme Court established the appropriate measure of ''loss causation'' in a civil securities fraud matter, but the Court has never spoken on the causation necessary for finding ''actual loss'' under the Guidelines. Both the Fifth and Second Circuits find that the civil standard should drive a sentencing court in a fraud matter. The Ninth Circuit disagrees. The Ninth Circuit's stand-alone position is insufficient to render this issue ripe for the Supreme Court, but it can be quickly addressed by the United States Sentencing Commission.

The United States Sentencing Commission should amend its Guidelines to incorporate the principles of the *Dura* loss causation analysis. Such an amendment is consistent with the Commission's principles, which recognize that ''ordinarily, the sentences of defendants convicted of federal offenses should reflect the nature and *magnitude* of the loss caused or intended by their crimes.''[76]

Further, the *Dura* approach adopted by the Fifth and Second Circuits is more legally sound and protective than the approach adopted by the Ninth Circuit. Before a criminal defendant is punished for causing a particular loss, there should be evidence beyond a reasonable doubt that the defendant in fact *caused* the claimed

[54] *Id.* at 449.
[55] *Id.*
[56] *Id.* at 449-50.
[57] *Id.* at 452.
[58] *Id.*
[59] *Id.*
[60] 587 F.3d 1038 (9th Cir. 2009).
[61] *Id.* at 1039.
[62] *Id.* at 1040.
[63] *Id.*
[64] *Id.* at 1041.
[65] *Id.*
[66] *Id.*
[67] *Id.*
[68] *Id.* at 1043.
[69] *Id.*
[70] *Id.* at 1044.
[71] *Id.*
[72] *Id.*
[73] *Id.* at 1044-45.
[74] *Id.* at 1045.
[75] *Id.*
[76] United States Sentencing Guidelines § 2B1.1, Commentary (emphasis added).

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loss. Applying the *Dura* analysis in federal criminal sentencings would help to ensure that this constitutionally-required standard is met. Further, the *Dura* analysis is consistent with the Guidelines, which allow courts great latitude in determining a proper sentence. At the same time, the Guidelines are amorphous, and the Commission's authoritative standard that the *Dura* analysis applies in federal criminal sentencings would create needed clarity and continuity in this area. Even the United States Securities & Exchange Commission has insinuated the propriety in official adoption of the *Dura* analysis in federal criminal sentencings.[77]

[77] Matthew T. Martens, United States Securities and Exchange Commission Chief Litigation Counsel, Division of Enforcement, Testimony before the United States Sentencing Commission (Feb. 16, 2011), available at www.ussc.gov (last visited August 25, 2011).