SECURITIES FRAUD CRIME

Circuits Split Over Securities Fraud Sentencing

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This summer, Richard Berger will be resentenced by a court that now must calculate the loss attributable to his securities fraud conviction according to a rule that the U.S. Court of Appeals for the 9th Circuit adopted in November as a result of Berger's appeal. *U.S. v. Berger,* 587 F.3d 1038 (9th Cir. 2009).That approach diverges from the approach of the other three federal circuits that have considered the issue. At a time when the U.S. Department of Justice is promising uniformity in sentencing, Berger's case has created a circuit split regarding the proper method for calculating loss in criminal securities fraud cases. As a result, defendants convicted of such offenses in the 9th Circuit will very likely receive higher sentences than defendants sentenced elsewhere. This disparity regarding the most material factor involved in the sentencing of economic crimes could soon attract the interest of the U.S. Supreme Court.

Berger, the former president and chief executive officer of Craig Consumer Electronics Inc., a publicly traded company, was convicted of 12 counts of bank and securities fraud. Berger and his co-defendants employed accounting schemes to falsify information in daily certifications required as part of Craig's credit agreement with a consortium of banks. Banks lent millions of dollars to Craig in reliance on the false statements. In May 1996, Craig made an initial public offering. In connection with the IPO, Berger allegedly misrepresented the company's viability and financial condition to the public. In 1997, an audit revealed accounting irregularities, requiring Craig to restate earnings for part of 1995 and 1996. The company's stock fell from $4.99 to 99 cents per share. The 9th Circuit acknowledged that the extent to which this decline resulted from the restated earnings, as opposed to unrelated external market forces, was uncertain. *U.S. v. Berger,* 473 F.3d 1080 (9th Cir. 2007).

The district court initially sentenced Berger to six months' imprisonment. On appeal, the 9th Circuit vacated the sentence and remanded for resentencing. On remand, the district court, employing the so-called "modified market capitalization theory" (i.e., comparing the change in stock value of other, unaffiliated companies after accounting irregularities in those companies' records were disclosed to the market), calculated that the shareholder loss triggered a 14-level sentencing enhancement, from level 16 to 30. This enhancement increased the applicable sentencing range from 21 to 27 months to 97 to 121 months, a more than fourfold increase.

On his second appeal to the 9th Circuit, Berger argued that the district court erred in failing to employ the civil securities fraud "loss calculation" approach espoused by the Supreme Court in *Dura Pharmaceuticals Inc. v. Broudo,* 544 U.S. 336 (2005). In *Dura,* the Court ruled that, to sustain a private cause of action for securities fraud under § 10(b) of the Securities Exchange Act of 1934 and Rule 10(b), a plaintiff bears the burden of proof to show that the fraudulent conduct was disclosed publicly to the market and that the disclosure caused loss to shareholders. Merely alleging the stock overvaluation itself was insufficient to overcome a motion to dismiss. The Court stated: "[A]s a matter of pure logic, at the moment the transaction takes place, the plaintiff has suffered no loss; the inflated purchase payment is offset by ownership of a share that at that instant possesses equivalent value." Id. at 342 (emphasis in original).

Although the Supreme Court has not addressed the issue of whether *Dura*'s loss causation principles apply to criminal cases, three federal circuits have endorsed the Dura approach in such cases. In *U.S. v. Olis,* 429 F.3d 540 (5th Cir. 2005), the 5th Circuit noted that "[t]he civil damage measure [of *Dura]* should be the backdrop for criminal responsibility both because it furnishes the standard of compensable injury for securities fraud victims and because it is attuned to stock market complexities." Id. at 546. Applying the loss causation principles of *Dura,* the 5th Circuit vacated Olis' sentence. On remand, the district court recalculated the loss caused by Olis and found a smaller loss than originally calculated. This resulted in a lower offense level — and a 75% reduction in the time he had to serve.

Similarly, the 2d Circuit, in *U.S. v. Rutkoske,* 506 F.3d 170 (2d Cir. 2007), noted that it could "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." Id. at 179. Like its predecessor in *Olis,* the 2d Circuit remanded for resentencing, in this case to account for the effect of other factors relevant to the decrease in share price.

In *U.S. v. Nacchio, (*10th Cir. 2009), the 10th Circuit rejected a "net profit" measure in an insider-trading case and, citing *Dura,* directed the trial court on remand to "focus on arriving at a figure that more closely approximates Mr. Nacchio's gain resulting from the offense of insider trading" (emphasis in original).

In *Berger,* however, the 9th Circuit declined to follow suit for two reasons. First, the court held that the concerns addressed by the Court in *Dura* are not implicated in the criminal context because, in a civil fraud action, the plaintiff bears the burden to prove the amount and cause of loss he sustained, while in the criminal context, the court is more concerned with the loss caused as a result of the fraud. As the court put it: "In criminal sentencing…a court gauges the amount of loss caused, i.e., the harm that society as a whole suffered from the defendant's fraud." 587 F.3d at 1044 (emphasis in original).

Second, the 9th Circuit found the scope of *Dura*'s civil rule to be limited by the U.S. Sentencing Guidelines, which, in the court's view, supported the measure of loss by stock overvaluation. The 9th Circuit looked to § 2F1.1 of the guidelines (now § 2B1.1) for fraud cases, which states that "the court need only make a reasonable estimate of the loss." Note 8(a) to the comments to § 2F1.1 (now Note 3(C) to § 2B1.1), the court said, approves measuring loss by overvaluation in stating that "[a] fraud may involve the misrepresentation of the value of an item that does have some value." Thus, the 9th Circuit held that, if *Dura's* rule were to be applied to criminal sentencing enhancement, "that principle's plain rejection of the overvaluation loss measurement method would collide with Congress' clear endorsement of that method." Id. at 1045.

It could be argued that the court's reasoning in rejecting *Dura's* application to the criminal context is circular. The court tries to differentiate *Dura*'s loss-causation standard by finding that, in the criminal context, the court needs to take into account total harm caused by a defendant. Yet whether "society as a whole" suffered a loss involves the same analysis as whether a particular plaintiff sustained a loss. Both analyses are highly fact-based, requiring the effect of the fraud to be isolated from other marketplace factors that affect share price. Indeed, the 9th Circuit noted that courts remain required "to show that actual defendant-caused loss occurred." Thus, although claiming that the *Dura* standard has no application in the criminal context, the 9th Circuit, in a somewhat roundabout way, seemingly agrees that actual loss cannot be based on some artificially inflated price.

The 9th Circuit's rejection of *Dura* in the criminal context creates an obvious disparity between civil versus criminal defendants. The practical effect is that criminal defendants are subject to standards less exacting than their counterparts in civil cases. This disparity is particularly curious since one would expect the sentencing standard to be more exacting in criminal cases, given the civil liberties at issue.

The decision not only rejects the reasoning of *Dura* and of three other circuits, but also will cause further inflated sentences in securities fraud cases in which defendants are already subject to disproportionately high loss tables and multiple, redundant upward adjustments. Attorney General Eric Holder Jr. and Assistant Attorney General Lanny Breuer have recently denounced disparities in white-collar sentencing, and the ruling contravenes their concerns as well.

Opponents of *Berger* argue that the 9th Circuit's reliance on the Sentencing Guidelines, which are merely advisory, to support a less exacting standard is misplaced, as Congress itself has mandated that a sentencing court must consider the "nature and circumstances of the offense and the history and characteristics of the defendant" to prevent the imposition of a sentence that is "greater than necessary" and does not "reflect the seriousness of the offense." The guidelines themselves speak in terms of reduction in value of securities, not harm to society. Note 3(C) to § 2B1.1 defines loss in securities fraud cases as "the reduction that resulted from the offense in the value of equity securities or other corporate assets."

Given the circuit split, the Supreme Court will quite probably need to decide soon whether sentences in criminal fraud cases involving publicly traded stock may be based on artificial estimates of shareholder loss, as advocated by the *Berger* court, or on more exacting standards, as advocated by the Supreme Court in *Dura.*

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