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Sentencing Based on Loss

Jeff Ifrah
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A recent 2d U.S. Circuit Court of Appeals decision represents a significant development for defendants confronting federal criminal securities fraud prosecutions, as it provides them greater traction for challenging sentence enhancements based on loss. This case has important implications for corporate executives who may be vulnerable to allegations of securities fraud, as well as for the corporations with whom they are affiliated. The more rigorous loss causation standard in criminal proceedings, as set forth in this decision, may make it more difficult for plaintiffs to recover excessive damages awards in subsequent civil proceedings.

The 2d Circuit has now joined the 5th Circuit in refining the way in which economic loss associated with underlying fraudulent conduct may be used to enhance a defendant's sentence. In *U.S. v. Rutkoske*, 506 F.3d 170 (2d Cir. 2007), the 2d Circuit remanded a securities fraud case due to the district court's "basic failure at least to approximate the amount of loss caused by fraud." Id. at 180. Rejecting the government's argument that the U.S. Supreme Court's analysis in *Dura Pharmaceuticals Inc. v. Broudo*, 544 U.S. 336 (2005) — a civil securities fraud case — does not apply to criminal sentencing, the court stated: "[W]e 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." 506 F.3d at 179.

Sentencing under the advisory guidelines

To appreciate the import of the 2d Circuit's decision, one has only to consider how loss calculation typically drives prosecution of federal securities fraud cases. In such cases, the key component of sentencing is the amount of loss caused by the defendant's fraudulent conduct. Under the current U.S. Sentencing Guidelines, a defendant who causes $10,000 in losses is subject to a four-level enhancement, while a defendant who causes $1 million in losses is subject to a 16-level enhancement. See U.S.S.G. § 2B1.1(b)(1) (2007). Added to a base level of 6 under Category I, a four-level enhancement increases a sentence of zero to six months by a maximum of one year. A 16-level enhancement, on the other hand, increases the same base sentence by roughly three to 3 and 3 1/2 years. The guidelines advise that sentencing courts are to "make a reasonable estimate of loss, given the available information." Sentencing judges make that "reasonable estimate of loss" based on a preponderance of the evidence.

As discussed in more detail below, the district court in *Rutkoske* relied on a loss estimate of roughly $12.1 million to enhance David Rutkoske's sentence by 15 levels. See U.S.S.G. § 2F1.1(b)(1)(P) (1998). Rutkoske was sentenced under the 1998 guidelines, which call for a 15-level enhancement for losses between $10 million and $20 million, plus an additional 10-level enhancement on other grounds. This brought Rutkoske's total offense level to 31, which calls for a sentence of 9 to 11.25 years. He was sentenced to 9 years. Thus the loss calculation not only served as the basis for a $12.1 million restitution order, it added roughly 7 years to his prison term.

Applying 'Dura' in context of criminal securities fraud

Defendants have attempted to reduce their exposure to sentence increases of up to 1,800% by arguing that the more rigorous loss calculation standards announced in *Dura* apply with equal force in criminal securities fraud cases. In *Dura*, the Supreme Court considered what an investor-plaintiff must show in a civil securities fraud case to prove the amount of economic loss proximately caused by the defendant's fraudulent conduct.

The court unanimously rejected the 9th Circuit's facile approach to loss causation, which simply required plaintiffs to prove that the stock price was inflated on the date of purchase due to the defendant's fraud.

Speaking for the court, Justice Stephen G. Breyer stated that "[normally], in [fraud-on-the-market cases], an inflated purchase price will not itself constitute or proximately cause the relevant economic loss." 544 U.S. at 342. This is so, Breyer explained, because the purchaser suffers no economic loss upon purchasing the inflated share. Whether the purchaser later sells the share at a loss depends on any number of factors, such as "changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events, which taken separately or together account for some or all of that lower price." Id. at 343. An inflated purchase price may prove to be a necessary condition of loss causation; by itself, it is insufficient.

The federal district court in *Rutkoske* was one of many trial courts to consider whether *Dura*-like precision is required to satisfy the "reasonable estimate" standard for loss causation under the guidelines. At sentencing, the trial judge enhanced Rutkoske's sentence based on a methodology proffered by the government's expert witness. Specifically, the judge estimated the amount of loss to stockholders based on stock purchases and sales between January 1997 (one month after the alleged securities fraud conspiracy began) and July 29, 1999, the last date for which the parties had reporting forms otherwise known as "blue sheets."

The court found that Rutkoske's fraudulent conduct caused a total decline in value of approximately $12 million. On that basis and other grounds, the judge increased Rutkoske's offense level by 25 levels, to 31, and sentenced him to 9 years, as opposed to a sentencing range of 1.75 to 2.25 years with only the 10-level enhancement.

On appeal, Rutkoske argued that his sentence was unreasonable due to the judge's improper calculation of loss. The government countered that the loss determination was reasonable, insisting that the principles set forth in *Dura* should not apply in criminal cases. The 2d Circuit held for the defendant and remanded the case for sentencing.

In its decision, the 2d Circuit relied heavily on *U.S. v. Olis*, 429 F.3d 500, 546 (5th Cir. 2005), the first case by a federal court of appeals to require the application of *Dura*'s loss causation principles in the context of criminal sentencing. (In *Olis*, the government's estimate of economic loss was more than $105 million, causing the defendant's sentence to increase to 22.5 to 23 years from 1.25 to 1.75 years without the loss enhancement.) Quoting the 5th Circuit, the *Rutkoske* court reasoned: "The Guidelines state that '[t]he court need only make a reasonable estimate of the loss.' . . . Nevertheless, a court of appeals must 'determine . . . whether the trial court's method of calculating the amount of loss [is] legally acceptable.' " *Rutkoske*, 506 F.3d at 178. Like the 5th Circuit, the 2d Circuit found the Supreme Court's guidance in *Dura* useful. To be legally acceptable, a loss calculation under the guidelines must represent economic loss proximately caused by fraudulent conduct, not simply economic loss correlated to allegedly fraudulent conduct.

The court of appeals acknowledged that loss calculation is not an exact science but noted that sentencing judges should use principles such as those set forth in *Dura* to conduct an analysis grounded in economic reality — one that attempts to exclude losses attributable to extrinsic forces in order to derive a more precise estimate of loss caused by the defendant's conduct.

Assessing loss calculation methodologies

Applying *Dura*'s loss causation principles, the *Rutkoske* and *Olis* courts have cited the following criteria as relevant for determining whether a particular loss calculation methodology is "legally acceptable":

• Whether the methodology is anchored to relevant events, such as disclosure of fraud, rather than arbitrary dates, such as the end of available "blue sheet" data.

• Expert opinion proffered at sentencing.

• Market performance, generally.

• Market-sector performance.

• Market performance of comparable companies.

• And whether the stock trades in a "thin" market.

Federal courts of appeals specifically have frowned upon the use of "inflated purchase price" and oversimplified "market capitalization" approaches as bases for computing loss. See id. at 179-80 (inflated purchase price); *Dura Pharmaceuticals Inc.*, 544 U.S. at 340 (same); *Olis*, 429 F.3d at 546 (market capitalization).

Federal district courts have rejected other methodologies, such as the "IPO theory," which uses total proceeds of an initial public offering as a proxy for amount of loss. See *U.S. v. Bakhit*, 218 F. Supp. 2d 1232 (C.D. Calif. 2002). At least one district court has rejected the use of "defendant's intended gain" in a case in which calculating the victims' loss was feasible. See *U.S. v. Snyder*, 291 F.3d 1291, 1295-96 (11th Cir. 2002). And the district court in *Olis* rejected the prosecutor's reliance on a novel loss methodology on the ground that the government's adoption of aggressive, inconsistent and unsupported theories does not promote the goals of uniform sentencing and fairness. See *Olis*, 429 F.3d at 547 n.12.

The 2d Circuit's decision in *Rutkoske* gives defendants in securities fraud cases greater incentive to go to trial rather than negotiate a plea. Now they stand a chance of fighting the crushing loss estimates that, until now, have provided the bases for exponential sentence increases.

Jeff Ifrah *(ifrahj@gtlaw.com), a shareholder in the Washington office of Greenberg Traurig, concentrates his practice on litigating civil and criminal cases against the federal government. He is co-author of Federal Sentencing for Business Crimes (LexisNexis 2007). Jeff Hamlin, a contract associate in the Washington office, assisted with the drafting of this article.*