University of Denver Criminal Law Review

Volume 2 | Issue 1 Article 4

January 2012

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Keywords
Causation, Criminal law, Fraud, Securities law, Sentencing, States

REVISITING *DURA PHARMACEUTICALS*: LOSS CAUSATION & CRIMINAL SECURITIES FRAUD SENTENCING

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I. INTRODUCTION

In securities fraud cases, it is generally difficult to determine what losses are attributable to a defendant's fraud, because downward movements in stock price may reflect market realities that have nothing to do with the fraud. The principle of loss causation has thus played an important role in civil and, more recently, criminal securities fraud cases. In the civil context, the federal courts use loss causation to determine loss attributable to the defendant and, hence, damages. In the criminal context, certain federal courts have used the loss causation principle to aid in determining the appropriate sentence.

Under the Sentencing Guidelines, the major factor influencing the securities fraud defendant's sentencing range is the size of the loss to investors. But, calculating loss attributable to a defendant's misconduct in a securities fraud case is a complicated matter.

For this reason, it is especially important for courts to adhere to strict loss causation principles, lest criminal securities defendants be made to serve time for losses they had no hand in causing. Nevertheless, a recent Ninth Circuit case, *United States v. Berger*, has rejected the application of civil loss-causation principles in criminal cases, creating a circuit split on this very important issue.[1]

The *Berger* decision adds another layer of arbitrariness to sentencing in criminal securities cases. In recent years, securities sentencing has caught flak due to sentencing disparities apparently dependent on the judge assigned to the case. In *United States v. Booker*, the Supreme Court held that the Federal Sentencing Guidelines were advisory, not mandatory, in order to cure a Sixth Amendment challenge to the Guidelines' constitutionality.[2] After *Booker*, sentencing has been more judge-dependent, especially in securities cases. Now, *Berger* has added a strong jurisdictional element to securities fraud cases.

The potential implications of this jurisdictional element are broad. Criminal securities defendants in the Ninth Circuit will face higher sentencing ranges under the Guidelines. In most cases, this will probably result in similarly higher sentences as judges adhere to the sentencing ranges prescribed by the Guidelines. In at least some cases, however, it is possible that the higher sentencing range under the Guidelines may cause judges to ignore the Guidelines and impose non-Guidelines sentences. With the matter up to judicial discretion, which defendants will be successful in availing themselves of a departure from the Sentencing Guidelines under *Booker* may ultimately be arbitrary.

This paper is divided into six parts. Part I briefly discusses the use of the loss-causation principle in the civil context. Part II outlines the mechanics of the Sentencing Guidelines in criminal securities cases. Part III describes the application of the loss-causation principle in criminal cases. Part IV discusses the circuit split created by the *Berger* case. Part V discusses the implications of this split for criminal securities defendants. And finally, Part VI further discusses those implications in light of the discretion afforded judges in *Booker*.

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[1] 587 F.3d 1038, 1042-45 (9th Cir. 2009).

[2] 543 U.S. 220, 226 (2005).

II. CIVIL LOSS CAUSATION & *DURA PHARMACEUTICALS*[3]

In *Dura Pharmaceuticals, Inc. v. Broudo* — the lead case on loss causation — the Supreme Court held that merely establishing the price of a security as inflated when purchased was insufficient to prove loss causation.[4] As the Court noted, the point of the private securities fraud action is to protect investors against economic losses caused by defendant misconduct, not to provide broad investor insurance against market losses.[5] But, at the time of purchase, the plaintiff has suffered no loss because the inflated purchase price is offset by the inflated market value of the share purchased.[6] Thus, it is only at the time of corrective disclosure — when the market assimilates news of the false information — that plaintiff suffers any harm.[7] Moreover, a strong causal nexus must exist between a defendant's misconduct and the later, lower market value because the lower price may reflect extrinsic factors such as changed economic circumstances or investor expectations.[8]

III. SECURITIES FRAUD SENTENCING GUIDELINES

According to the current version of the Sentencing Guidelines, a loss of just one million dollars results in an increase of 16 in the offense level,[9] a loss of $100 million results in an increase of 26,[10] and a loss of $400 million — the highest figure included in the Sentencing Guidelines — results in an increase of 30 levels.[11] Thus, failing to properly distinguish losses caused by a defendant's misconduct from other losses can cause serious problems, especially when we are dealing with large corporations. Companies in the S&P 500 often lose more than $100 million in market capitalization per day. Where the natural ebb and flow of market prices can create losses of this size, it is imperative that criminal courts ensure that the loss figures used in sentencing actually match up with real losses caused by the defendant's fraud.

IV. CRIMINAL LOSS CAUSATION

At first, courts limited *Dura*'s stricter loss-causation requirements to civil fraud-on-the-market claims under the Private Securities Litigation Reform Act (PSLRA).[12] Eventually, however, the *Dura* analysis began entering into common law and, then, criminal securities fraud cases. In the criminal context, the Second and Fifth Circuits have applied the loss-causation principle when determining the size of the loss attributable to a criminal defendant.

In *United States v. Olis*, the Fifth Circuit applied *Dura*'s loss-causation principle in defining loss under the criminal Sentencing Guidelines.[13] In that case, defendant Jamie Olis, Vice President of Finance at Dynegy Corporation, was convicted of securities fraud for his role in a fraudulent scheme to disguise a $300 million loan as income from operations.[14] This scheme —

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3 Dura Pharms., Inc. v. Broudo, 544 U.S. 336 (2005).

4 *Id.* at 342.

5 *Id.* at 345-46.

6 *Id.* at 342.

7 *Id.* at 344-45 (quoting Restatement (Second) of Torts § 548A cmt. b (1977)).

8 *Id.* at 342-43.

9 U.S. SENTENCING GUIDELINES MANUAL § 2B1.1(b)(1)(I) (2011).

10 *Id.* § 2B1.1(b)(1)(N).

11 *Id.* § 2B1.1(b)(1)(P).

12 *Dura Pharms.*, 544 U.S. at 345.

13 429 F.3d 540, 546 (5th Cir. 2005).

14 *Id.* at 541.

nicknamed "Project Alpha" — misled investors into believing that Dynegy was more financially sound than it actually was by treating the $300 million loan as an asset rather than a liability on the company's balance sheet.[15]

Rigidly applying the Sentencing Guidelines, the district court reluctantly sentenced Olis to 292 months incarceration.[16] Unsurprisingly, the most significant factor contributing to his sentence was the size of the loss, which added 26 levels to the base offense level.[17] The court of appeals reversed, citing the insufficiency of the district court's loss-causation analysis, which did not take into account the impact of extrinsic factors on the decline in Dynegy's stock price.[18] During the period at issue, other public energy trading firms experienced a decline in stock price, and Dynegy's own stock price had declined prior to the restatement of the Project Alpha cash flows due to its failed bid to acquire then-faltering Enron.[19] These facts were brought up by an expert witness at sentencing, but the court ignored the expert's analysis in favor of the government witness's trial testimony that favored a simple market capitalization test.[20] Because the sentencing court did not take extrinsic factors into account — and instead relied solely on the decline in Dynegy's market capitalization in calculating the size of investors' loss — the court of appeals concluded that the district court's loss-causation numbers did not adequately reflect economic reality.[21] On remand, the district court found the record insufficient to calculate actual investor loss and used the intended loss of $79 million as the basis for a Guidelines sentence of 151 to 188 months—just over half the prior range.[22]

In *United States v. Ebbers* — a highly publicized securities fraud case against former WorldCom CEO Bernard Ebbers — the Second Circuit noted that serious loss-causation issues may arise in calculating the loss caused by a criminal securities defendant.[23] Like the *Olis* court, the Second Circuit noted the failure of the market capitalization test to take into account other factors that may have contributed to a decline in stock price.[24] Nevertheless, the Second Circuit affirmed Ebbers's 25-year sentence because even an adjusted loss figure would total over $1 billion — far in excess of the $100 million for which he received a 26-level Guidelines enhancement.[25]

In *United States v. Rutkoske*, however, the Second Circuit had more appropriate facts to delve into the applicability of the *Dura Pharmaceuticals* loss-causation analysis to criminal cases.[26] In that case, defendant David Rutkoske was sentenced to 108 months, in accordance with the Sentencing Guidelines, for his role in a fraudulent market-making scheme that artificially inflated the stock price of certain thinly-traded securities.[27] The size of the loss to investors —

[15] *Id.*

[16] *Id.* at 543. This sentence was at the bottom of the Guidelines range of 292 to 365 months. *See* U.S SENTENCING GUIDELINES MANUAL § 2B1.1 (2011).

[17] *Olis*, 429 F.3d at 545.

[18] *Id.* at 548-49.

[19] *Id.* at 548.

[20] *Id.*

[21] *Id.* at 548-49.

[22] United States v. Olis, No. H-03-217-01, 2006 WL 2716048, at *10 (S.D. Tex. 2006). The application notes for the Sentencing Guidelines provide that "loss is the greater of actual loss or intended loss." U.S. SENTENCING GUIDELINES MANUAL § 2B1.1 cmt. n.2(a) (2011).

[23] 458 F.3d 110, 126-28 (2d Cir. 2006).

[24] *Id.* at 127 (citing *Olis*, 429 F.3d at 547).

[25] *Id.* at 128.

[26] 506 F.3d 170, 179-80 (2d Cir. 2007).

[27] *Id.* at 174. This sentence was at the bottom of the Guidelines range of 108 to 135 months. *See* U.S SENTENCING GUIDELINES MANUAL § 2B1.1 (2011).

calculated to be just over $12 million — resulted in a 15-level Guidelines enhancement.[28] This was by far the largest contributor to the defendant's total offense level of 31, up from a base offense level of 6.[29] On appeal, the Second Circuit held that a sentencing court must consider other factors relevant to a decline in stock price when calculating loss, in accord with the Supreme Court's holding in *Dura Pharmaceuticals*.[30] In doing so, the court approvingly cited the *Ebbers* dicta and the Fifth Circuit's holding in *Olis*.[31] It noted that separating other causes of loss cannot be an exact science and the Guidelines allow for a "reasonable estimate" of loss.[32] Nevertheless, it concluded that this difficulty does not diminish the sentencing court's basic duty to approximate the loss caused by defendant's fraud separately from market forces.[33]

V. THE NINTH CIRCUIT & *BERGER*

Until recently, the Second and Fifth Circuits had the last word on loss causation in criminal securities cases, both extending the *Dura Pharmaceuticals* holding to criminal cases. In 2009, however, in *United States v. Berger*, the Ninth Circuit rejected the *Dura Pharmaceuticals* loss-causation requirement as applied to criminal sentencing — creating a circuit split with the Fifth and Second Circuits.[34]

In that case, defendant Richard Berger was President, CEO, and Chairman of Craig Consumer Electronics (Craig), a publicly traded consumer electronics company.[35] Craig had a $50 million revolving line of credit with a consortium of banks, and the amount that Craig could have drawn on its credit line was based on the value of inventory and accounts receivable.[36] During his tenure at Craig, Berger concealed Craig's financial condition from the bank consortium by employing various fraudulent accounting techniques, resulting in millions of dollars of funding based on overstated collateral.[37] Berger also misrepresented Craig's financial condition in SEC reports in connection with Craig's initial public offering (IPO).[38]

At sentencing, the district judge imposed a Guidelines sentence of 97 months after applying a 14-level enhancement — from 16 to 30 — for a loss of $5.2 million.[39] In calculating the size of the loss to shareholders, the sentencing judge adopted the government's "modified market capitalization theory," comparing changes in stock price at other, unaffiliated companies following market disclosure of accounting irregularities.[40] The average depreciation at these companies — 26.5% — was applied to the value of Craig's IPO, resulting in a calculated loss of $2.1 million.[41] To this figure was added $3.1 million for losses to the bank consortium.[42]

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[28] *Rutkoske*, 506 F.3d at 174. This figure corresponds to the enhancement for a loss greater than $10 million. *See* U.S SENTENCING GUIDELINES MANUAL § 2B1.1 (2011).

[29] *Rutkoske*, 506 F.3d at 174.

[30] *Id.* at 180.

[31] *Id.* at 178-79.

[32] *Id.*

[33] *Id.* at 180.

[34] United States v. Berger, 587 F.3d 1038, 1045-46 (9th Cir. 2009); *cf.* United States v. Olis, 429 F.3d 540, 546 (5th Cir. 2005); *Rutkoske*, 506 F.3d at 179.

[35] *Berger*, 587 F.3d at 1040.

[36] *Id.*

[37] *Id.*

[38] *Id.*

[39] *Id.* at 1041. The Guidelines range was from 97 to 121 months. *See* U.S SENTENCING GUIDELINES MANUAL § 2B1.1 (2011).

[40] *Berger*, 587 F.3d at 1041.

[41] *Id.*

On appeal, Berger challenged the district court's shareholder loss calculation, citing the civil standard for loss causation and the Second and Fifth Circuit precedents applying that standard in criminal cases.[43] Under the *Dura Pharmaceuticals* rule, Berger's appeal would have been open-and-shut. In *Dura Pharmaceuticals*, the Supreme Court in no uncertain terms prohibited civil damages based on an inflated stock price, requiring instead that a plaintiff show that the defendant's fraudulent conduct was revealed to the market and caused plaintiff's losses.[44] But, in *Berger*, the stock went to zero and was pulled off the exchange before the alleged corrective disclosure.[45] Undeterred, the sentencing court calculated shareholder loss on the theory that Craig's stock price was inflated at the time of purchase — clearly contravening the *Dura* rule.[46]

Nevertheless, after reviewing the case literature from its sister courts, the Ninth Circuit refused to adopt the rule espoused by the Second and Fifth Circuits, applying *Dura*'s stricter loss-causation requirements to criminal sentencing.[47] It provided two reasons for its decision:

> First, we believe that the primary policy rationale of *Dura Pharmaceuticals* for proscribing overvaluation as a valid measure of loss does not apply in a criminal sanctions context. Second, application of *Dura Pharmaceuticals's* [*sic*] civil rule to criminal sentencing would clash with the parallel principles in the Sentencing Guidelines . . . .[48]

The first rationale the Ninth Circuit gives is dubious at best. According to the *Berger* court, the policy implicated by *Dura Pharmaceuticals* applies only when we are concerned with the damages suffered by a particular plaintiff and not by society at large,[49] but it is not clear what difference this distinction makes. If no victims suffer damages, it is wholly unclear what damages society has suffered. The harm caused by the defendant — the focus of criminal sentencing — is nothing more than the aggregate loss suffered by the victims of his fraud. In a footnote, the Ninth Circuit even goes on to admit that the *Dura* rule may be applicable when calculating criminal restitution, without really detailing why restitution figures should be different from harm figures.[50]

The second rationale is equally unwarranted. Put simply, the *Berger* court argued that the reference to "overvaluation" in the comments to the Sentencing Guidelines conflicts with *Dura*'s insistence that an inflated stock price is insufficient to show damages.[51] Though the comments to the Sentencing Guidelines do reference "overvaluation," the reference is made only in passing.[52] The purpose of that comment is to illustrate that "[a] fraud may involve the misrepresentation of the value of an item that does have some value (in contrast to an item that is worthless)."[53] It is clear under these circumstances that the comment was not intended to serve as a guide for calculating loss — a process which is far more complicated than subtracting

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[42] *Id.*

[43] *Id.* at 1039.

[44] Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 344-47 (2005).

[45] *Berger*, 587 F.3d at 1040-41.

[46] *Id.* at 1043.

[47] *Id.*

[48] *Id.*

[49] *Id.* at 1044.

[50] *Id.* at 1044 n.7.

[51] *Id.* at 1045.

[52] *See* U.S. SENTENCING GUIDELINES MANUAL § 2F1.1, cmt. n.7(a) (1995) (deleted 2001).

[53] *Id.*

the true value of a stock from the inflated price paid by an investor. In the comment's simple illustration, the defendant "represents" that the stock has a particular price.[54] In the real world, the defendant would have made certain representations, but these representations only touch upon value — in the end, it is the market that is the true arbiter of value. Thus, a security may be overvalued, but that overvaluation may be the result of market sentiment in addition to fraudulent representations. The defendant is only responsible for losses causally related to the fraudulent representations made to the market.[55] This is the *Dura* rule.[56]

Despite the Ninth Circuit's reluctance to apply the civil loss-causation standard to criminal cases, this does not mean that Ninth Circuit judges are completely free to ignore loss causation as a principle. In fact, in *Berger*, the Ninth Circuit actually remanded for resentencing because of the inadequacy of the loss-calculation methodology employed by the sentencing court.[57] Nevertheless, the refusal to apply *Dura*'s loss-causation principle to criminal cases is significant because the methodology supported by the *Berger* opinion does not adequately address external causes of declines in stock price. The *Dura* Court's worry that defendants will be made to insure against such declines may thus come to fruition, with the added caveat that defendants will be forced to pay with years of their life and not merely money damages.

VI. WHAT DOES THIS MEAN FOR SECURITIES FRAUD DEFENDANTS?

The Ninth Circuit has a troubled history with the loss-causation element of securities cases. It was the Ninth Circuit's formulation of loss causation that was overturned by the Supreme Court in *Dura Pharmaceuticals*. Since the Ninth Circuit has opposed loss causation in the civil context, it should be no surprise that the court would limit its application in the criminal context. But, by doing so, the Ninth Circuit has created a potentially great disparity in sentences for criminal securities defendants in these circuits. Given the Ninth Circuit's relatively lax criminal loss-causation requirement, the calculated size of the loss attributable to a defendant will likely be higher — perhaps significantly higher — in the Ninth Circuit than in other jurisdictions. And since the Sentencing Guidelines put a lot of weight on the size of the loss, criminal securities defendants in the Ninth Circuit may face significantly higher sentences than their peers in the Second and Fifth Circuits.

The potential disparity in sentences is fairly unsettling, but what is most disturbing about this state of affairs is that criminal defendants in the Ninth Circuit — whose liberty is at stake — are afforded less protection than civil defendants who are subject only to money damages.[58] In *Dura*, the Supreme Court noted that the purpose of the PSLRA was to provide economic recourse to plaintiffs for losses attributable to defendant's misconduct, not to insure plaintiffs against all market losses.[59] The same principle should be even truer in criminal securities fraud cases. Defendants ought to be punished for losses attributable to their misconduct, not for losses attributable to unrelated movements in stock price.

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[54] *Id.*

[55] Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 345-47 (2005).

[56] *Id.* at 345-46.

[57] United States v. Berger, 587 F.3d 1038, 1045 (9th Cir. 2009).

[58] Craig McCann, *Rethinking Sentencing Guidelines in Criminal Securities Frauds* (2005) (unpublished op-ed piece), *available at* http://lawprofessors.typepad.com/whitecollarcrime_blog/files/craig_mccann_on_the_ebbers_sentence.pdf.

[59] *Dura Pharms.*, 544 U.S. at 345.

VII. *BOOKER* & JUDICIAL DISCRETION UNDER THE GUIDELINES

Prior to the Sixth Amendment challenge in *United States v. Booker*, the Sentencing Guidelines were mandatory.[60] *Booker* severed those provisions making them mandatory,[61] with the result that judges now have discretion to impose non-Guidelines sentences in addition to sentences anywhere within the Guidelines range, and many judges have exercised this discretion. Because judges have discretion to give non-Guidelines sentences, Ninth Circuit judges may be pushed to do so if the Ninth Circuit's loss-causation rules result in penalties not fitting for crimes committed.

Even prior to the loss-causation debate, certain judges have expressed concern over the harsh arithmetic approach to calculating sentencing in white-collar cases. For example, in *United States v. Adelson*, the sentencing judge criticized the emphasis on the size of the loss under the Sentencing Guidelines, concluding: "Since successful public companies typically issue millions of publicly traded shares[,] . . . the precipitous decline in stock price that typically accompanies a revelation of fraud generates a multiplier effect that may lead to Guidelines offense levels that are, quite literally, off the chart."[62] Needless to say, the defendant in that case, Richard Adelson, a belated participant in the alleged fraud, received a non-Guidelines sentence — 3.5 years compared to a Guidelines sentence of life imprisonment.[63] Although the Second Circuit in the *Ebbers* case ultimately concluded that Ebbers's 25-year sentence was reasonable, the court noted that "[u]nder the Guidelines, it may well be that all but the most trivial frauds in publicly traded companies may trigger sentences amounting to life imprisonment . . . ."[64] In *Olis*, the district court on remand was charged both with revising its calculated loss under the Sentencing Guidelines and with determining the reasonableness of imposing a Guidelines sentence (the original sentence having preceded the Supreme Court's decision in *Booker*).[65] After revising its Guidelines sentence to almost half the previous calculation, the district court further concluded that even this sentence was unreasonable under the circumstances.[66]

To some extent this mitigates the negative impact of lax loss-causation rules because the Sentencing Guidelines effectively provide a ceiling and not the floor for criminal sentences.[67] Conscientious judges can always reduce sentences so that they more accurately reflect a defendant's moral culpability. At the same time, not all judges will be willing to ignore the Guidelines, and the *Berger* rule will increase the effect judicial discretion has on sentences in criminal securities cases. Indeed, there may be many Richard Adelsons in the Ninth Circuit's future. Rather than blindly enforcing the Sentencing Guidelines in securities cases, Ninth Circuit judges increasingly will be forced to take actual criminal culpability seriously.

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[60] United States v. Booker, 543 U.S 220, 233 (2005).

[61] *Id.* at 258.

[62] 441 F. Supp. 2d 506, 509 (S.D.N.Y 2006). The reference to being off the charts is indeed quite literal here: the offense level under the Guidelines in *Adelson* was 46 and the guideline charts top at 43, which translates to life imprisonment. *See* U.S SENTENCING GUIDELINES MANUAL § 2B1.1 (2011).

[63] *Adelson*, 441 F. Supp. 2d at 507.

[64] United States v. Ebbers, 458 F.3d 110, 129 (2d Cir. 2006).

[65] United States v. Olis, No. H-03-217-01, 2006 WL 2716048, at *1-2 (S.D Tex. 2006).

[66] *Id.* at *11-13.

[67] Upward departures from the Sentencing Guidelines are possible but unlikely.