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UNITED STATES V. BERGER: THE REJECTION OF CIVIL LOSS CAUSATION PRINCIPLES IN CONNECTION WITH CRIMINAL SECURITIES FRAUD

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ABSTRACT

In United States v. Berger*, a Ninth Circuit panel declined to apply the civil loss causation principles established by the United States Supreme Court in* Dura Pharmaceuticals, Inc. v. Broudo *in connection with sentencing in a criminal securities fraud prosecution. The Ninth Circuit declined to follow Second and Fifth Circuit decisions endorsing the application of* Dura Pharmaceuticals *to criminal sentencing, creating a circuit split. This Article examines this split over how to apply the loss causation principles of* Dura Pharmaceuticals *in connection with sentencing in criminal securities fraud prosecutions. In addition, this Article discusses the implications of each approach for criminal securities fraud prosecutions, and more specifically, for sentencing.*

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INTRODUCTION

In 2005, the Supreme Court resolved a circuit split by holding in *Dura Pharmaceuticals, Inc. v. Broudo*[1] that a private plaintiff claiming securities fraud must show both that the alleged fraud was disclosed to the market and the disclosure caused a loss to shareholders, that is, that the share price fell after the defendant's fraud became known. No longer could civil plaintiffs merely allege that the price of a security was inflated on the date of the purchase because of a defendant's misrepresentation. Although the Supreme Court's decision applied to loss calculation in civil securities fraud cases, the Second and Fifth Circuits have since suggested that the loss causation principles described in *Dura Pharmaceuticals* also apply in sentencing for *criminal* securities fraud cases.[2]

In *United States v. Berger*, the Ninth Circuit diverged from the Second and Fifth Circuits and held that federal judges need not follow the loss causation principles that apply in private securities actions when calculating the amount of loss for U.S. Sentencing Guidelines purposes in criminal securities fraud cases.[3] This ruling could have a profound effect on criminal securities fraud prosecutions in the Ninth Circuit, resulting in sentencing enhancements for

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[1] Dura Pharms., Inc. v. Broudo, 544 U.S. 336 (2005).

[2] *See* United States v. Rutkoske, 506 F.3d 170 (2d Cir. 2007); United States v. Olis, 429 F.3d 540 (5th Cir. 2005).

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

defendants in criminal securities fraud cases where "fraud-on-the-market" formed the basis of the shareholders' losses.

This Article explores the Supreme Court's decision in *Dura Pharmaceuticals* as it applies to loss causation in civil securities fraud cases. This Article then examines the U.S. Sentencing Guidelines and the importance of loss calculation in sentence determination. Next, this Article examines the split among the Second, Fifth, and Ninth Circuits in applying the loss causation principles of *Dura Pharmaceuticals* in connection with sentencing in criminal securities fraud prosecutions. Finally, this Article addresses the implications of each approach on criminal securities fraud prosecutions, and more specifically, on sentencing.

I. THE SUPREME COURT'S DECISION IN *DURA PHARMACEUTICALS, INC. V. BROUDO*

In *Dura Pharmaceuticals, Inc. v. Broudo*, the Supreme Court addressed whether a plaintiff could satisfy the loss causation requirement simply by establishing that the price of the security on the date of purchase was inflated because of the defendant's misrepresentation.[4] The plaintiffs were a class of individuals who bought stock in Dura Pharmaceuticals, Inc. (Dura) on the public securities market between April 15, 1997, and February 24, 1998.[5] The plaintiffs alleged that during that period, Dura's managers and directors allegedly made false statements regarding the company's profits and prospects for future approval of its products by the Food and Drug Administration (FDA).[6]

On February 24, 1998, Dura announced that its earnings would be lower than expected, and the company's shares lost almost half their value in trading the next day.[7] Nine months later, Dura announced that the FDA would not approve its new product, resulting in another drop in its share price.[8] The plaintiffs argued that they suffered damages by paying artificially inflated prices for Dura securities in

4 Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 338 (2005).
5 *Id.* at 339.
6 *Id.*
7 *Id.* (falling from about $39 per share to about $21).
8 *Id.*

reliance on the integrity of the market.[9]

The Court recognized that an inflated purchase price in itself does not necessarily equate to or proximately cause the economic loss.[10] At the time of initial purchase, the stock still reflects an economic value of the inflated purchase price. If the purchaser sells the stock at that instant, or at any other time before the truth of the misrepresentation becomes public, the purchaser will not have realized any loss.[11] Even if the purchaser sells the stock at a lower price subsequent to the public release of the relevant truth, the lower price "may reflect, not the earlier misrepresentation, but 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."[12] From this, the Court reasoned that "the most logic alone permits . . . is that the higher purchase price will *sometimes* play a role in bringing about a future loss."[13]

For these reasons, and relying on the common-law roots of securities fraud actions, which have long required that a plaintiff show actual damages, the Court held that an investor must show that the fraud was publicly revealed and that the public disclosure caused the investor's loss.[14] In other words, an investor may not establish loss causation by alleging that the security price was inflated because of the defendant's misrepresentation. In effect, the Court rejected the notion that stock over-valuation resulting from so-called "fraud-on-the-market" may form the basis for a plaintiff's damages award in a private securities action.[15]

II. APPLICATION OF LOSS CAUSATION PRINCIPLES TO CRIMINAL SECURITIES FRAUD SENTENCING

Although the Supreme Court has not applied its *Dura*

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[9] *Id.* at 340.
[10] *Id.* at 342.
[11] *Id.* at 342-43.
[12] *Id.*
[13] *Id.* at 343.
[14] *Id.* at 345-47.
[15] *Id.* at 341-43.

Pharmaceuticals loss causation principles to sentencing enhancements in criminal securities fraud cases, two federal circuit courts have applied the principles in such a context. In *United States v. Olis*, the Fifth Circuit determined that the civil loss causation principles described in *Dura Pharmaceuticals* should inform criminal securities fraud sentencing. The Second Circuit endorsed the application of *Dura Pharmaceuticals*' principles to criminal sentencing in *United States v. Rutkoske*. However, before discussing *Olis* and *Rutkoske*, it is necessary to examine the importance of loss calculation in a criminal setting under the U.S. Sentencing Guidelines.

A. Loss Under the U.S. Sentencing Guidelines

Using a detailed set of rules, tables, and adjustments that look at the entire conduct of a convicted defendant, the U.S. Sentencing Guidelines produce a numerical score, or "offense level," which then translates into a range of months of imprisonment. Since the Supreme Court's decision in *United States v. Booker*,[16] federal district judges are no longer required to impose a sentence within the U.S. Sentencing Guidelines. They nonetheless remain obligated to calculate and consider the applicable sentencing range under the U.S. Sentencing Guidelines.[17] Therefore, the calculation of "loss" under the U.S. Sentencing Guidelines remains a critical issue at sentencing in criminal securities fraud cases.

A defendant's sentence in a securities case can depend heavily on the calculation of loss under the U.S. Sentencing Guidelines. Section 2B1.1 of the U.S. Sentencing Guidelines governs the sentencing calculation for fraud-based crimes, including criminal securities fraud.[18] This section provides a base offense level for fraud-based

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

[17] *Id.* at 246 ("make the Guidelines system advisory while maintaining a strong connection between the sentence imposed and the offender's real conduct").

[18] U.S. SENTENCING GUIDELINES MANUAL § 2B1.1 (2010). It should be noted that Section 2F1.1 of the U.S. Sentencing Guidelines used to govern the sentencing calculation for fraud-based crimes but was consolidated into Section 2B1.1 along with the guidelines for theft and property destruction, effective November 1, 2001. *See* U.S. SENTENCING GUIDELINES MANUAL app. C, amend. 617 (2010). Section 2F1.1 was applied at the trial court in both *United States v. Berger* and *United States v. Rutkoske*. *See* United States v. Berger, 587 F.3d 1038, 1044-45 (2d Cir.

crimes, which may be increased depending on various factors, including the amount of loss attributed to the offense. The U.S. Sentencing Guidelines explain that "loss serves as a measure of the seriousness of the offense and the defendant's relative culpability and is a principal factor in determining the offense level under this guideline."[19] As the amount of loss increases, the offense level calculation increases, and thus the sentence increases.[20] These increases range from zero for losses of $5,000 or less, to as many as 30 for losses exceeding $400 million.[21] For a defendant charged with criminal securities fraud, the difference between a loss of $0 and a loss exceeding $400 million can mean the difference between probation and more than 19 years in prison.[22]

Guidance for determining the meaning of "loss" within the U.S. Sentencing Guidelines is found in Application Note 3 of Section 2B1.1.[23] Courts are expected to apply the greater of actual loss or intended loss.[24] In determining the actual or intended loss attributable to a defendant's conduct, the U.S. Sentencing Guidelines require only that courts make a reasonable estimate of the loss, given the available information.[25] Due to the deference given to sentencing judges, courts have used a variety of methods to calculate losses under the U.S. Sentencing Guidelines.[26]

2009); United States v. Rutkoske, 506 F.3d 170, 174 (2d Cir. 2007).

[19] U.S. SENTENCING GUIDELINES MANUAL § 2B1.1 cmt. background.

[20] *Id.* at § 2B1.1(b)(1).

[21] *Id.*

[22] Assuming no other enhancements, a first-time offender involved in a fraudulent scheme resulting in a loss of $5,000 or less faces a sentencing range of zero to six months. *See* U.S. SENTENCING GUIDELINES MANUAL § 2B1.1(a) (2010); U.S. SENTENCING GUIDELINES MANUAL § 2B1.1(b)(1)(A) (2010); U.S. SENTENCING GUIDELINES MANUAL ch. 5, pt. A (2010). If the loss exceeds $400 million, that same defendant would be subject to a 30-level increase to the base offense level, resulting in a sentencing range of 188-235 months. *See* U.S. SENTENCING GUIDELINES MANUAL § 2B1.1(b)(1)(P) (2010); U.S. SENTENCING GUIDELINES MANUAL ch. 5, pt. A (2010).

[23] U.S. SENTENCING GUIDELINES MANUAL § 2B1.1 cmt. n.3 (2010).

[24] *Id.*

[25] *Id.* at § 2B1.1 cmt. n.3(C).

[26] *See* United States v. Holliman, 291 F.3d 498 (8th Cir. 2002) (relying on losses arising from the defendant's relevant conduct); United States v. Piggie, 303 F.3d 923 (8th Cir. 2002) (relying on intended loss); United States v. Manas, 272

The deference given to sentencing judges has resulted in uncertainties in how loss is calculated. Combined with the great significance given the loss figure by the U.S. Sentencing Guidelines, this deference has become a primary source of concern for defendants and their counsel in criminal securities fraud cases. The following federal circuit court decisions address this concern in applying *Dura Pharmaceuticals* loss causation principles to sentencing enhancements in criminal securities fraud cases.

B. The Fifth Circuit's Decision in United States v. Olis

The Fifth Circuit became the first appellate court to extend the *Dura Pharmaceuticals* decision to criminal securities fraud cases in *United States v. Olis*.[27] James Olis was sentenced to 292 months in prison for securities fraud, mail and wire fraud, and conspiracy arising from his work as Senior Director of Tax Planning and International (and later, Vice President of Finance) at Dynegy Corporation (Dynegy) on a transaction called "Project Alpha."[28] The offense level was "extraordinarily high" as a result of the district court's finding that the fraud-related losses were in excess of $100 million.[29]

In examining Olis's sentence, the court noted that *Dura Pharmaceuticals*' principles provided useful guidance for determining criminal responsibility.[30] The court looked to these principles for guidance because they "furnish[] the standard of compensable injury for securities fraud victims and because [they are] attuned to stock market complexities."[31] The Fifth Circuit vacated Olis' sentence, finding that the district court did not take into account "the impact of extrinsic factors on Dynegy's stock price decline" in its

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F.3d 159 (2d Cir. 2001) (relying on gain to the defendant); United States v. Hedges, 175 F.3d 1312 (11th Cir. 1999) (relying on actual loss).

[27] United States v. Olis, 429 F.3d 540 (5th Cir. 2005).

[28] *Id.* at 541.

[29] *Id.* at 542, 545 ("The most significant determinant of Olis' sentence is the guidelines loss calculation. By the district court's reasoning, this added twenty-six levels to his base offense level and alone placed Olis in a punishment range exceeding fifteen years' imprisonment.").

[30] *Id.* at 546.

[31] *Id.*

approach to the loss calculation.[32] Accordingly, the Fifth Circuit remanded to the district court to reconsider the U.S. Sentencing Guidelines, including a recalc-ulation of the loss caused by Olis's conduct.[33] On remand, the district court sentenced Olis to 72 months in prison; 220 months less than his original sentence.[34]

C. *The Second Circuit's Decision in* United States v. Rutkoske

In 2007, the Second Circuit reached a similar conclusion in *United States v. Rutkoske*.[35] David Rutkoske was convicted of securities fraud and conspiracy to commit securities fraud. He was sentenced to 108 months in prison based on a U.S. Sentencing Guidelines range determined from a total offense level of 31.[36] The offense level included a 15-level enhancement for loss of more than $10 million.[37] Rutkoske objected to the loss calculated by the presentence report, which had been based on the trial testimony of a National Association of Securities Dealers expert.[38]

Like the Fifth Circuit, the Second Circuit noted that *Dura Pharmaceuticals*' principles provided useful guidance for determ-ining criminal responsibility.[39] The Second Circuit saw "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."[40] The court acknowledged that the U.S. Sentencing Guidelines allowed for a "reasonable estimate" of loss and that such allowance remained pertinent.[41] However, the district court failed to at least approximate the amount of loss caused

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[32] *Id.* at 548-49.
[33] *Id.* at 549.
[34] United States v. Olis, Criminal No. H-03-217-01, 2006 WL 2716048, at *13 (S.D. Tex. Sept. 22, 2006).
[35] United States v. Rutkoske, 506 F.3d 170 (2d Cir. 2007).
[36] *Id.* at 174.
[37] *Id.* (The 15-level enhancement had the effect of adding 87 months onto Rutkoske's sentence).
[38] *Id.*
[39] *Id.* at 179.
[40] *Id.*
[41] *Id.*

by the fraud absent other factors relevant to a decline in the company's share price.[42] Accordingly, the Second Circuit remanded to the district court to recalculate the amount of loss, for both sentencing and restitution purposes.[43]

III. THE NINTH CIRCUIT DECLINES TO APPLY LOSS CAUSATION PRINCIPLES IN CONNECTION WITH CRIMINAL SECURITIES FRAUD SENTENCING

In *United States v. Berger*, the Ninth Circuit explicitly declined to follow the Fifth and Second Circuits' extension of *Dura Pharmaceuticals*' principles to criminal sentencing.[44] Richard Berger, President, Chief Executive Officer, and Chairman of the Board of Craig Consumer Electronics, Inc. (Craig),[45] was convicted of 12 counts of bank and securities fraud for misrepresenting his company's fiscal viability and financial condition in connection with his company's IPO.[46] Craig was required to restate its past earnings in the year following Berger's misrepresentation as a result of an audit of the company's accounting records.[47] In the months following the restatement, the company's stock price fell from $4.99 to $0.99 per share.[48]

The district court initially sentenced Berger to only six months imprisonment due to its belief that "controlling authority prohibited it from applying any sentencing facts not found by the jury."[49] On appeal, the Ninth Circuit vacated Berger's sentence and remanded to the district court for resentencing in light of *United States v. Booker*.[50] On remand, the district judge sentenced Berger to 97 months in prison.[51] This sentence was on the low end of a U.S. Sentencing Guidelines range of 97 to 121 months which was based

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[42] *Id.* at 180.
[43] *Id.*
[44] United States v. Berger, 587 F.3d 1038, 1042-43 (9th Cir. 2009).
[45] *Id.* at 1040.
[46] *Id.* at 1041.
[47] *Id.* at 1040.
[48] *Id.*
[49] *Id.* at 1041.
[50] *Id.*
[51] *Id.*

on an offense level that included a 14-level sentencing enhancement for a calculated loss of $5.2 million.[52] On his second appeal, Berger argued that the district court erred by not employing the *Dura Pharmaceuticals* approach in calculating loss.[53]

While recognizing that two other circuit courts had applied *Dura Pharmaceuticals*' principles to the calculation of loss in criminal sentencing, the Ninth Circuit held that the primary rationale behind the *Dura Pharmaceuticals* decision did not apply in criminal cases.[54] The Ninth Circuit reasoned that the Supreme Court in *Dura Pharmaceuticals* was "concerned principally with the *plaintiff's* ability to show that he suffered actual loss caused directly—and exclusively—by the defendant's fraudulent misrepresentation."[55] This is in contrast to criminal cases, where the court is concerned with the loss to society as a whole as opposed to a particular person's loss.[56] Therefore, even if an individual's loss cannot be directly linked to the fraud, there could still be general loss to society based on the defendant's fraud.[57]

In addition, the court found that the application of *Dura Pharmaceuticals* ran contrary to the U.S. Sentencing Guidelines. Specifically, application of *Dura Pharmaceuticals'* loss causation principles to criminal sentencing enhancements would conflict with "Congress's clear endorsement" of the overvaluation loss measurement method.[58] By rejecting the application of *Dura Pharmaceuticals* in criminal sentencing, the Ninth Circuit relied on its prior decision in *United States v. Hicks*[59] to find that "a defendant's sentence [must be based on the] harm that resulted from the acts or omissions of the defendant."[60]

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[52] *Id.*
[53] *Id.* at 1042.
[54] *Id.* at 1043.
[55] *Id.* at 1044.
[56] *Id.*
[57] *Id.*
[58] *Id*. at 1045.
[59] United States v. Hicks, 217 F.3d 1038 (9th Cir. 2000).
[60] *Berger*, 587 F.3d at 1044 (quoting *Hicks*, 217 F.3d at 1048).

IV. IMPLICATIONS OF THE NINTH CIRCUIT'S DECISION IN *UNITED STATES V. BERGER*

The amount of loss caused by securities fraud can be a key amplifying factor at sentencing; it has the potential to increase the offense level by as many as 30 levels.[61] For example, in *Olis*, the defendant's base offense level was increased by 26 levels due to a loss calculation of $105 million.[62] The large impact of that loss calculation lessens the impact of more relevant issues, such as the actual motive of the perpetrator, extenuating circumstances, and the personal benefit received by the defendant.[63] Instead, these important issues have been completely replaced by complex loss calculations.

Also, greater uncertainty exists under the Ninth Circuit's decision in *Berger* because the U.S. Sentencing Guidelines provide little guidance to courts with respect to how loss should be calculated. Courts are expected to apply the greater of actual loss or intended loss in its determination of loss.[64] In addition, courts need only make a reasonable estimate of loss.[65] Since numerous theories have developed to calculate loss, a reasonable estimate of loss may differ depending on the sentencing court. Furthermore, these different methods will likely be upheld in the Ninth Circuit, allowing for a broad range of criminal sentences arising from similar conduct.

In addition, the Ninth Circuit's decision in *Berger* will likely have an effect on pretrial negotiations among prosecutors and criminal securities fraud defendants. These defendants will face the tough choice between entering into a plea agreement with a predefined sentence or risk receiving a potentially greater sentence based on the sentencing court's calculation of loss under *Berger*. However, within the Second and Fifth Circuits, defendants will likely have a greater incentive to go to trial rather than negotiate a plea, because they will be less at risk of incurring a large sentence increase due to the sentencing court's loss calculation.

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[61] U.S. SENTENCING GUIDELINES MANUAL § 2B1.1(b)(1)(P) (2010).

[62] United States v. Olis, 429 F.3d 540, 543 (5th Cir. 2005).

[63] Kevin P. McCormick, Comment, *Untangling the Capricious Effects of Market Loss in Securities Fraud Sentencing*, 82 TUL. L. REV. 1145, 1149 (2008).

[64] U.S. SENTENCING GUIDELINES MANUAL § 2B1.1 cmt. n.3(A) (2010).

[65] *Id.* at § 2B1.1 cmt. n.3(C) (2010).

CONCLUSION

The Ninth Circuit's decision in *Berger* has set up a circuit conflict among the Second, Fifth, and Ninth Circuits. This may lead to uncertainty as to the calculation of loss in criminal securities fraud sentencing throughout the country. Defendants in the Ninth Circuit and perhaps other circuits may now be at the mercy of prosecutors to reach a plea agreement before trial to avoid the nearly exponential sentence increase that may come with the calculation of market loss at sentencing. For those choosing to go to trial, their lawyers must attempt to persuade sentencing courts to adopt conservative approaches to U.S. Sentencing Guidelines calculations to avoid any significant increase to the defendant's offense level. Given the split on this issue, it may be necessary for the Supreme Court to clarify whether civil loss causation principles should be applied in criminal securities fraud cases. Until this issue is resolved by the Supreme Court, criminal securities fraud defendants will have a tough choice to make: whether to settle with prosecutors before trial or risk a large sentence increase due to market loss calculations.