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Notes

Playing Hot Potato in the Market: The Ninth Circuit's Better Approach to Calculating Loss for Securities Fraud Sentencing

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In United States v. Berger*, the Court of Appeals for the Ninth Circuit departed from the Second and Fifth Circuits regarding the standard required to determine loss for securities fraud under the Federal Sentencing Guidelines. Unlike its sister circuits, the Ninth Circuit held that the Supreme Court's reasoning in* Dura Pharmaceuticals, Inc. v. Broudo *for loss causation in civil securities fraud actions did not apply to the criminal sentencing context. Instead, the Ninth Circuit endorsed price inflation, which was rejected in* Dura Pharmaceuticals*, as a method of determining loss under the Guidelines. This Note examines the circuits' decisions in light of the crime and punishment of securities fraud and concludes that the Ninth Circuit's reasoning better accords with the culpability of securities fraud offenders.*

* J.D. Candidate, University of California, Hastings College of the Law, 2012. I am very appreciative to Professor Aaron Rappaport for helping me untangle the world of loss calculation; his patience and feedback were invaluable. I would also like to thank the *Hastings Law Journal* editors who made excellent suggestions to improve this Note. Finally, I have to thank my parents, who have consistently shown me great support, even as I made them listen to securities law explanations. Their forbearance is an attribute to which we should all aspire.

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INTRODUCTION

The past decade and a half have seen tremendous shifts in American securities markets. From the dot-com bubble and its burst to the recent subprime mortgage catastrophe, the markets have reached incredible heights and then rapidly plummeted.[1] At their pinnacle, Enron's shares traded in August 2000 at just over $90 per share.[2] By December 2001, their price was less than $1, and the company had filed for bankruptcy.[3] WorldCom and Dynegy experienced similarly dramatic rises and

1. *See* STEPHEN P. UTKUS, VANGUARD RESEARCH, MARKET BUBBLES AND INVESTOR PSYCHOLOGY (2011).

2. *See* BETHANY MCLEAN & PETER ELKIND, THE SMARTEST GUYS IN THE ROOM: THE AMAZING RISE AND SCANDALOUS FALL OF ENRON 318 (2003).

3. *Id.* at 403, 405.

precipitous falls.[4] More recently, BearStearns, AIG, and Lehman Brothers have undergone dramatic changes in fortune.[5]

The architects of these calamities have faced criminal convictions and headline-grabbing sentences.[6] Bernard Ebbers was convicted for his role in the scheme to artificially inflate WorldCom's shares and was sentenced to twenty-five years,[7] at the time the longest sentence for a corporate officer convicted of securities fraud.[8] Jeffrey Skilling, Enron's CEO at the time of its financial collapse, received twenty-four years.[9] Bernard Madoff pled guilty to numerous counts of securities fraud, mail and wire fraud, and falsifying records, and received a sentence of 150 years.[10] For many, these long sentences represent an appropriate comeuppance for the once high-flying executives.[11]

Several factors, including changes in the political and public climates, contribute to the determination of these long sentences.[12] But the most important factor by far is the loss sustained from the fraud, because under the Federal Sentencing Guidelines (the "Guidelines") loss is the primary enhancement factor.[13] Loss dwarfs other enhancements, making the loss calculation the most important determinant in sentencing.[14]

In 2009, the Court of Appeals for the Ninth Circuit diverged from the Second and Fifth Circuits regarding the appropriate standard for calculating loss for criminal sentences.[15] The Second and Fifth Circuits adopted the Supreme Court's civil loss calculation reasoning from *Dura Pharmaceuticals, Inc. v. Broudo* to establish standards for criminal

4. *See* Jamie Doward, *Day the WorldCom World Was Turned Upside Down: The Giant's Fall*, OBSERVER, June 30, 2002, at 4; *Shocks to the System: Will the Light Keep Burning in America This Summer?*, ECONOMIST, Aug. 10, 2002, at 54–55.

5. *See* ANDREW ROSS SORKIN, TOO BIG TO FAIL: THE INSIDE STORY OF HOW WALL STREET AND WASHINGTON FOUGHT TO SAVE THE FINANCIAL SYSTEM—AND THEMSELVES 5–6, 355–63, 392–408 (2010).

6. *See, e.g.*, Alexei Barrionuevo, *Skilling Sentenced to 24 Years*, N.Y. TIMES, Oct. 24, 2006, at C1; Carrie Johnson, *Ebbers Gets 25-Year Sentence for Role in WorldCom Fraud*, WASH. POST, July 14, 2005, at A1; Kevin McCoy, *As Victims Cheer, "Evil" Madoff Gets 150 Years: Judge Cites "Staggering Human Toll" of Scam*, U.S.A. TODAY, June 30, 2009, at A1. *But see* Gretchen Morgenson & Louise Story, *A Financial Crisis with Little Guilt*, N.Y. TIMES, Apr. 14, 2011, at A1.

7. Johnson, *supra* note 6.

8. *Id.*

9. Barrionuevo, *supra* note 6.

10. McCoy, *supra* note 6.

11. *See, e.g.*, Barrionuevo, *supra* note 6; Diana B. Henriques, *Madoff, Apologizing, Is Given 150 Years*, N.Y. TIMES, June 30, 2009, at A1.

12. *See Bosses Behind Bars*, ECONOMIST, June 12, 2004, at 59–60 (noting how the changes in the Guidelines emerged from Congress's reaction to the widespread damage from Enron-type frauds).

13. *See* U.S. SENTENCING GUIDELINES MANUAL § 2B1.1(b)(1) (2010); Derick R. Vollrath, *Losing the Loss Calculation: Toward a More Just Sentencing Regime in White-Collar Criminal Cases*, 59 DUKE L.J. 1001, 1008 (2010).

14. U.S. SENTENCING GUIDELINES MANUAL § 2B1.1(b)(1).

15. *Compare* United States v. Berger, 587 F.3d 1038, 1043 (9th Cir. 2009), *with* United States v. Rutkoske, 506 F.3d 170, 180 (2d Cir. 2007), *and* United States v. Olis, 429 F.3d 540, 546 (5th Cir. 2005).

sentencing.[16] The Ninth Circuit asserted that the retributive, society-based rationale for criminal punishment differed from the civil purpose of compensation and refused to apply *Dura Pharmaceuticals*' reasoning to criminal sentencing.[17] The circuits' disagreement embodies a broader conflict about determining white-collar criminals' culpability: Are they responsible for creating a virtual game of hot potato in the market, or are they only responsible for the losses sustained by the shareholders holding the shares when word of the fraud gets out and the game ends?

This Note addresses these competing theories for loss calculation under the Guidelines and argues that the Ninth Circuit's approach more accurately identifies the defendant's culpability and is the better approach. This Note is divided into three main Parts. Through a brief examination of the crime of securities fraud and the rationales underlying its prohibition, Part I assesses the policy implications instructing courts. Part II analyzes the punishment regimes in place under the Guidelines. Part III analyzes the different theories of loss calculation in light of these regimes, and ultimately advises that with certain modifications the Ninth Circuit's interpretation is the more appropriate standard for determining loss.

I. THE CRIME

To contextualize the circuit split, this Part introduces the law prohibiting securities fraud and briefly details the policies underlying its criminalization.

A. THE LAW

The Securities Exchange Act of 1934 (the "Exchange Act")[18] governs transactions on the secondary markets. The Act has numerous antifraud provisions, which prohibit insider trading and material misrepresentations in offers and sales of securities.[19] Loss calculation standards are particularly significant in sentencing for material misrepresentations because loss is often market-wide and can be substantial.[20] Calculating

16. *See Rutkoske*, 506 F.3d at 180 (discussing Dura Pharm., Inc., v. Broudo, 544 U.S. 336, 346 (2005)); *Olis*, 429 F.3d at 546 (same).

17. *Berger*, 587 F.3d at 1043.

18. Ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a–78pp (2010)).

19. *See, e.g.*, 15 U.S.C. § 78j(b) (2010) (prohibiting material misrepresentations); 17 C.F.R. § 240.10b-5 (2011) (prohibiting insider trading).

20. Compare Ebbers' twenty-five year sentence for a conviction for affirmative misrepresentations about the health of WorldCom with the sentencing imposed on Rex Shelby, an Enron employee who pled guilty to insider trading. Laurel Brubaker Calkins, *Ex-Enron Broadband Executive Sentenced for Insider Trading*, BUS. WK. (Mar. 28, 2011, 1:07 PM), http://www.businessweek.com/news/2011-03-28/ex-enron-broadband-executive-sentenced-for-insider-trading.html. Shelby sold his Enron shares immediately after he had misrepresented the profits Enron was generating. As an employee he had a duty to disclose the information he knew to the buyer of the shares. *Id.* He was

standards for market-wide manipulation is the center of the divergent treatment of sentencing among the circuit courts of appeals.[21] This Note, therefore, focuses on the prohibitions against material misrepresentations to the market.

Section 10b of the Exchange Act prohibits the use, "in connection with the purchase or sale of any security . . . , [of] any manipulative or deceptive device or contrivance."[22] Securities and Exchange Commission (SEC) Rule 10b-5, promulgated under the Act's antifraud provision, elaborates on the types of prohibited conduct.[23] Section 10b and Rule 10b-5 are catch-all antifraud provisions.[24] They reach beyond the parties to a transaction and prohibit broad swaths of conduct involving misleading or false information.[25] Corporate directors or officers who issue misleading or false information about a corporation can be criminally and civilly liable under the Act, even if they refrain from directly engaging in sales or purchases of stock.[26]

The SEC has primary responsibility for investigating violations of the Exchange Act. The SEC is limited to pursuing civil actions against offenders, but it can refer investigations to the Department of Justice for criminal prosecution.[27] The Exchange Act establishes criminal liability for willful violations of its provisions, with a maximum sentence of twenty years and a maximum fine of $5 million.[28] Criminal prosecution requires a showing that the defendant intentionally made a materially misleading or false statement in connection with the purchase or sale of a security.[29] Unlike a private plaintiff, who must show reasonable reliance

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sentenced to three months in a halfway house, three months of house arrest, two years of probation, and he will forfeit the profits he realized from the transaction. *Id.*

21. *See Berger*, 587 F.3d at 1040–41 (concerning a defendant who spread misinformation about his company's liabilities); *Rutkoske*, 506 F.3d at 173 (defendant misrepresented the nature of the company and the nature of the brokers' commissions); *Olis*, 429 F.3d at 542 (defendant mischaracterized liabilities as cash transactions).

22. 15 U.S.C. § 78j(b).

23. 17 C.F.R. § 240.10b-5.

24. *See* Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 174 (1994) ("Section 10(b) is aptly described as a catchall provision . . . ." (quoting United States v. Chiarella, 445 U.S. 222, 234–35 (1980))).

25. *Id.*

26. SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 862 (2d Cir. 1968) ("Rule 10b-5 is violated whenever assertions are made . . . in a manner reasonably calculated to influence the investing public . . . if such assertions are false or misleading or are so incomplete as to mislead irrespective of whether the issuance of the release was motivated by corporate officials for ulterior purposes.").

27. MARC I. STEINBERG & RALPH C. FERRARA, SECURITIES PRACTICE: FEDERAL AND STATE ENFORCEMENT § 7.15 (2d ed. 2010).

28. 15 U.S.C. § 78ff(a) (2010).

29. United States v. Goyal, 629 F.3d 912, 915 (9th Cir. 2010) (citing United States v. Smith, 155 F.3d 1051, 1063 (9th Cir. 1998)); *cf.* SEC v. Monarch Funding Corp., 192 F.3d 295, 308 (2d Cir. 1999) ("To have violated section 10(b) and Rule 10b-5, [the defendant] must have: (1) made a material misrepresentation or a material omission as to which he had a duty to speak, or used a fraudulent device; (2) with scienter; (3) in connection with the purchase or sale of securities."); SEC v.

and actual damages[30] to recover under the Exchange Act's implied civil cause of action,[31] the government need only establish the "impact of the scheme on the investor."[32]

The Exchange Act requires the government to show the party acted "willfully" in violating the provision.[33] A "willful" act is "intentional, deliberate, and not the result of an innocent mistake, negligence, or inadvertence"[34] but does not require knowledge that the action was a violation.[35] The crux of the "willful" showing is the defendant's knowledge the action was wrong, but not necessarily that the defendant knew it was illegal.[36]

B. The Policies

The decision to criminally prosecute for securities fraud often has political motivations, with the types of victims and the nature of the fraud playing significant roles.[37] The choice to prosecute also highlights the opposing policies and motivations that often underlie the criminalization of securities fraud and that influence the debate about culpability and punishment. Punishment schemes must balance these opposing views of the culpability of white-collar crime. The courts rely on and must balance these justifications when expanding and contracting the sentences for white-collar criminals.[38]

Federal securities laws address the potentially substantial harms that individual shareholders suffer as a result of securities fraud.[39] At the sentencing hearing of Jeffrey Skilling, Judge Simeon Lake noted, "As the many victims have testified, [Skilling's] crimes have imposed on

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Haligiannis, 470 F. Supp. 2d 373, 382 (S.D.N.Y. 2007) ("Courts have applied collateral estoppel in the securities fraud context because the elements necessary to establish civil liability under . . . 10(b) are identical to those necessary to establish criminal liability under . . . 10(b).").

30. *See* Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 341–42 (2005).

31. Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971) ("It is now established that a private right of action is implied under § 10(b).").

32. Palmer T. Heenan et al., *Securities Fraud*, 47 Am. Crim. L. Rev. 1015, 1043 (2010) (footnote omitted) (citing United States v. Amick, 439 F.2d 351, 359 n.12 (7th Cir. 1971)).

33. 15 U.S.C. § 78ff(a). It is less clear whether this level of intent is distinct from the level of intent required for civil actions. *See* Heenan, *supra* note 32, at 1026.

34. Heenan, *supra* note 32, at 1025.

35. United States v. Reyes, 577 F.3d 1069, 1080 (9th Cir. 2009) ("[O]ur circuit and others have rejected the argument that, in the context of securities fraud statutes, willfulness requires a defendant know that he or she was breaking the law." (citing United States v. Tarallo, 380 F.3d 1174, 1187–88 (9th Cir. 2004))).

36. *Id.* at 1079 (citing *Tarallo*, 380 F.3d at 1088).

37. *See* Miriam H. Baer, *Linkage and the Deterrence of Corporate Fraud*, 94 Va. L. Rev. 1295, 1297–98 (2008) (discussing the cycle of legislation and punishment following corporate scandals).

38. *See id.*; Ellen S. Podgor, *Throwing Away the Key*, 116 Yale L.J. Pocket Part 279, 283–84 (2007).

39. J. Scott Dutcher, Comment, *From the Boardroom to the Cellblock: The Justifications for Harsher Punishment of White-Collar and Corporate Crime*, 37 Ariz. St. L.J. 1295, 1299 (2005).

hundreds if not thousands a life sentence of poverty."[40] Judge Denny Chin justified Bernard Madoff's 150-year sentence by stating, "The message must be sent that Mr. Madoff's crimes were extraordinarily evil and that this kind of irresponsible manipulation of the system is not merely a bloodless financial crime that takes place just on paper, but that it is . . . one that takes a staggering human toll."[41]

In addition, outlawing manipulation and deception in securities transactions is an attempt to protect market integrity. "Fraud is bad," as one commentator pithily noted,[42] but an act of securities fraud generally impacts far more people than an act of common law fraud.[43] Securities fraud destabilizes the market, making investors skittish about investment and reducing liquidity in the market.[44] Stocks become either overvalued because of the fraudulent acts or undervalued because of fear of fraud.[45] Overall, the market becomes less efficient as market participants attempt to account for potentially fraudulent schemes.[46]

The goal of protecting market integrity is apparent from the Exchange Act's history. Congress enacted the Securities Act of 1933[47] and the Exchange Act against the backdrop of the 1929 market crash and subsequent Great Depression, which affected the entire American population. [48] Unemployment reached twenty-five percent; repossessions of houses and cars bought on credit were rampant.[49] The Acts were not just a way to protect investments, but also a way to prevent "[n]ational emergencies, which produce widespread unemployment and the dislocation of trade, transportation, and industry."[50]

However, despite the potential for widespread substantial harm to the market and to individual investors, white-collar criminals traditionally received lighter sentences because the public perceived them to be less culpable than other types of criminals.[51] As one commentator noted, "The American public generally has not been fearful of being victimized by white-collar crime."[52] Impersonal economic

40. Barrionuevo, *supra* note 6 (quoting U.S. District Court Judge Simeon T. Lake III).

41. McCoy, *supra* note 6 (quoting U.S. District Court Judge Denny Chin).

42. Robert A. Prentice, *The Inevitability of a Strong SEC*, 91 CORNELL L. REV. 775, 824 (2006).

43. *See id.* at 824–26 (arguing that securities fraud creates an inefficient market).

44. *Id.* at 824.

45. *Id.* at 825.

46. *Id.*

47. Ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a–77bbbb (2010)).

48. Jonathan R. Macey & Geoffrey P. Miller, *Origin of the Blue Sky Laws*, 70 TEX. L. REV. 347, 348 (1991); Stanley K. Schultz, *Crashing Hopes: The Great Depression*, AMERICAN HISTORY 102, http://us.history.wisc.edu/hist102/lectures/lecture18.html (last visited Dec. 23, 2011).

49. *See About the Great Depression*, DEP'T OF ENG., U. ILL. URBANA-CHAMPAIGN, http://www.english.illinois.edu/maps/depression/about.htm (last visited Dec. 23, 2011).

50. 15 U.S.C. § 78b(4) (2010).

51. Dutcher, *supra* note 39, at 1301.

52. *Id.*

crimes are seemingly less dangerous than the confrontational nature of "street crimes."[53] Moreover, critics have argued that white-collar crime unjustly conflates tort and criminal liabilities, and that white-collar criminals should be liable only for tort violations.[54] Others argue that white-collar criminals have skills that benefit society and therefore long sentences do not serve utilitarian goals.[55]

II. THE PUNISHMENT

The tensions underlying the criminality of securities fraud—protecting individual investors, ensuring market reliability, and preventing over-punishment—also influence its punishment regime.[56] The Guidelines represent the U.S. Sentencing Commission's attempt to adequately punish defendants and to effectively deter future criminal conduct.[57]

Violators face three different forms of liability: private civil actions by shareholders;[58] civil actions by the SEC;[59] and criminal conviction, imprisonment, or fines.[60] This Part considers the criminal punishment regime, beginning with a brief overview of the history of the Guidelines for white-collar crime, followed by a description of the current guidelines.

A. HISTORY

Congress created the Sentencing Commission under the Sentencing Reform Act of 1984[61] and charged it with establishing a uniform federal sentencing policy to eliminate disparities in offenders' sentences.[62] The Sentencing Commission drafted guidelines through which judges would determine the severity of the crime and the offender's criminal history.[63]

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53. *See id.*; Podgor, *supra* note 38, at 283–84.

54. Michael Kades, *Exercising Discretion: A Case Study of Prosecutorial Discretion in the Wisconsin Department of Justice*, 25 AM. J. CRIM. L. 115, 116–17 (1997).

55. *See* Podgor, *supra* note 38, at 279; *cf.* Vollrath, *supra* note 13, at 1021 (noting that current punishment schemes poorly account for the characteristics of the defendant).

56. *But see* Baer, *supra* note 37, at 1313 (arguing that the timing of enforcement is key to deterring corporate fraud because ending the fraud actually aids in the detection of the fraud, thus incentivizing continuous wrongdoing).

57. *See* Vollrath, *supra* note 13, at 1006. The U.S. Sentencing Commission is an independent agency charged with "establish[ing] sentencing policies and practices for the federal courts, including guidelines to be consulted regarding the appropriate form and severity of punishment for offenders convicted of federal crimes." U.S. SENTENCING COMM'N, 2010 ANNUAL REPORT 1 (2010).

58. *See* 15 U.S.C. § 78u–4 (2010); Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971).

59. 15 U.S.C. § 78u(d)(3).

60. 15 U.S.C. § 78ff (2010).

61. Pub. L. No. 98-473, §§ 211–239, 98 Stat. 1837, 1987–2001 (1984) (codified as amended at 18 U.S.C. §§ 3551–3586, 3601–3615, 3661–3683, 3742 and at 28 U.S.C. 991–998 (2010)).

62. 28 U.S.C. § 991(b)(1)(B) (2010); *see also* U.S. SENTENCING COMM'N, *supra* note 57, at 1.

63. *See* U.S. SENTENCING GUIDELINES MANUAL § 1B1.1 (2010). For a plain language explanation, see Stephen Breyer, *The Federal Sentencing Guidelines and the Key Compromises Upon Which They*

As originally promulgated, the guidelines were mandatory;[64] judges' departures from the guidelines were subject to appellate review.[65] Using the Commission's sentencing grid, judges sentenced within the range required by the two factors.[66] To determine the crime's severity, the guidelines provide a base offense level derived from the type of crime, to which judges can add points based on specific offense characteristics.[67]

When the Sentencing Commission created its initial guideline for white-collar criminal sentences, it specifically rejected the lax scheme already in place.[68] Instead of the previous leniency, the Commission sought to create "short but definite" sentences for white-collar criminals because they "might deter future crime more effectively than sentences with no confinement condition."[69]

These "short but definite" sentences began to grow longer. In 2001, the Economic Crime Package[70] significantly amended the Guidelines by merging fraud with other loss-based crimes in order to address a perception that white-collar sentencing remained too lenient.[71] In doing so, the Commission made loss—and courts' estimates of loss—the most significant factor in calculating white-collar defendants' sentences.[72] The Sarbanes-Oxley Act's passage in 2002[73] further changed the Guidelines, as Congress charged the Sentencing Commission with the task of increasing penalties for white-collar defendants to levels that would effectively deter future securities schemes.[74]

Rest, 17 HOFSTRA L. REV. 1, 6–7 (1988).

64. *See* 18 U.S.C. § 3553(b) (2010) (mandating that courts use the guideline range unless there are factors in the case that the Commission did not account for). The Supreme Court determined that section 3553(b) was unconstitutional in *United States v. Booker*, 543 U.S. 220, 244, 245 (2005), discussed in greater detail in Part II.B.

65. *See* 18 U.S.C. § 3742(e) (2010) (detailing the considerations appellate courts must consider when reviewing sentences, including whether the sentence was "outside the applicable guideline range"). The Supreme Court also excised this section in *Booker*, 543 U.S. at 259.

66. *See* U.S. SENTENCING GUIDELINES MANUAL § 1B1.1. For an example of the current guideline grid, see U.S. SENTENCING GUIDELINES MANUAL, ch. 5 pt. A.

67. *Id.* § 1B1.1.

68. Breyer, *supra* note 63, at 20–21.

69. *Id.* at 22.

70. This is the blanket term for the significant amendments by the Sentencing Commission to the Guidelines. *See* Mary Kreiner Ramirez, *Just in Crime: Guiding Economic Crime Reform After the Sarbanes-Oxley Act of 2002*, 34 LOY. U. CHI. L.J. 359, 378 (2003). With the amendments, the Commission intended to address a perception that white-collar crime was not being punished as severely as other crimes. *See* Sentencing Guidelines for United States Courts, 66 Fed. Reg. 30,512, 30,542 (June 6, 2001).

71. Ramirez, *supra* note 70, at 378–79.

72. *See id.* (noting that with the consolidation, penalties for higher losses became more severe).

73. Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 11, 15, 18, 28, & 29 U.S.C.).

74. Ramirez, *supra* note 70, at 386.

B. The Federal Sentencing Guidelines Today

The Supreme Court's decision in *United States v. Booker* changed the Guidelines from a mandatory sentencing scheme to advisory guidelines.[75] Nevertheless, the guidelines remain the starting point for sentence determination.[76] A departure, therefore, is always relative to the initially calculated sentence. A consideration of the current Guidelines for fraud reveals the importance of loss calculation to the sentence determination.

For committing a crime involving "fraud and deceit," a defendant convicted of securities fraud receives a sentence guided by section 2B1.1 of the Guidelines.[77] Like many of the guidelines, section 2B1.1 addresses several different but related crimes.[78] Larceny, property damage, fraud, and offenses involving counterfeit instruments all fall under its provisions.[79] Resulting loss by third parties is the common thread throughout these crimes and loss is the primary tool in determining the sentence for each.[80]

Section 2B1.1 establishes two base offense levels: for offenses with statutory maximums of twenty years or greater, the base offense level is seven; for any other offense, the base offense level is six.[81] Securities fraud has a statutory maximum of twenty years and qualifies for the heightened base offense level.[82] The special offense characteristics add enhancements to this base level. The Guidelines have enhancements tailored for securities fraud,[83] but the loss enhancement dilutes their

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75. 543 U.S. 220, 259 (2005) (finding that mandatory guidelines based on enhancements found by the judge, rather than the jury, violated defendants' Sixth Amendment right to a jury trial).

76. *Id.* at 264.

77. U.S. Sentencing Guidelines Manual § 2B1.1 (2010).

78. *Id.*; *see, e.g.*, *id.* § 2B3.1 (dealing with robbery, armed robbery); *id.* § 2G3.1 (dealing with the transportation of obscene matter, its provision to minors, and misleading domain names).

79. *Id.* § 2B1.1.

80. *Id.*; *see also* Ramirez, *supra* note 70, at 378–79.

81. U.S. Sentencing Guidelines Manual § 2B1.1(a).

82. *See* 15 U.S.C. § 78ff(a) (2010).

83. Three special offense characteristics other than loss enhance a defendant's sentence for securities fraud. First, the number of victims of the fraud also enhances the sentence. U.S. Sentencing Guidelines Manual § 2B1.1(b)(2). Second, if the defendant received more than $1 million from the fraud the level increases by two. *Id.* § 2B1.1(b)(14). Alternatively, the level increases by four if the defendant

> (i) substantially jeopardized the safety and soundness of a financial institution; (ii) substantially endangered the solvency or financial security of an organization that, at any time during the offense, (I) was a publicly traded company; or (II) had 1,000 or more employees; or (iii) substantially endangered the solvency or financial security of 100 or more victims.

Id. However, if the defendant's offense level is below twenty-four, engaging in either of these actions automatically raises the defendant's offense level to twenty-four rather than merely adding four levels. *Id.* Finally, if the defendant was an officer or director, a registered broker or dealer, or an investment advisor, her offense level increases by another four levels. *Id.* § 2B1.1(b)(17).

impact.[84] Under section 2B1.1, the loss enhancement starts at two offense levels for $5000 and increases to thirty levels for $400 million.[85] Without adding any of the enhancements targeting securities fraud, loss enhancement can add between seventeen and twenty years to a defendant's sentence.[86] Moreover, all of the losses resulting from the "same course of conduct or common scheme" are relevant to the loss calculation.[87] A defendant's conviction on one count of securities fraud subjects her to punishment for all of the losses involved with that conviction.

Under the Guidelines, "loss is the greater of actual loss or intended loss."[88] The comments define actual loss as "the reasonably foreseeable pecuniary harm that resulted from the offense" and intended loss as "the pecuniary harm . . . intended to result from the offense."[89] The comments further elaborate that "reasonably foreseeable pecuniary harm" is the monetary harm the defendant "knew or . . . reasonably should have known, was a potential result of the offense."[90] Finally, the guidelines counsel that "[t]he court need only make a reasonable estimate of the loss . . . . based on available information" such as "[t]he approximate number of victims multiplied by the average loss to each victim," "[t]he reduction that resulted from the offense in the value" of shares, or "[m]ore general factors, such as the scope and duration of the offense and revenues generated by similar operations."[91]

The guidelines provide little direct guidance to courts in calculating losses. They emphasize the use of judicial discretion: "The sentencing judge is in a unique position to assess the evidence and estimate the loss based upon that evidence."[92]

C. Reactions to the Federal Sentencing Guidelines

The Guidelines' new severity for white-collar sentences has provoked a variety of reactions, which highlight the culpability debates facing courts. For example, Derick Vollrath noted that the Guidelines' directives are "unhelpful and circular" and fail to account for "thorny

84. *See* Peter J. Henning, *White Collar Crime Sentences After* Booker*: Was the Sentencing of Bernie Ebbers Too Harsh?*, 37 McGeorge L. Rev. 757, 767 (2006) ("While various modifications can have a small effect on the offense level for a defendant in a white collar crime case, the determination of loss can raise a sentence quickly from modest to substantial.").

85. U.S. Sentencing Guidelines Manual § 2B1.1(b)(1).

86. Depending on the loss, a defendant's sentence, assuming no criminal history, can jump from a range of zero to six months to a range of 210 to 262 months. *Id.*

87. *Id.* § 1B1.3.

88. *Id.* § 2B1.1 cmt. n.3(A).

89. *Id.* § 2B1.1 cmt. n.3(A)(i)–(ii).

90. *Id.* § 2B1.1 cmt. n.3(A)(iv).

91. *Id.* § 2B1.1 cmt. n.3(C).

92. *Id.* § 2B1.1 cmt. n.3(C).

causation issues."[93] Similarly, Judge Jed Rakoff in the Southern District of New York opined that the Guidelines place an "inordinate emphasis" on the actual or intended financial loss "in an effort to appear 'objective' . . . without, however, explaining why it is appropriate to accord such huge weight to such factors."[94] Ellen Podgor argued, "The accused becomes irrelevant in a sentencing world ruled by the cold mathematical calculations found in the [S]entencing Guidelines."[95]

Other commentators approve of the Guidelines' method for determining sentences for white-collar criminals. The Guidelines' harshness serves as an appropriate method of deterrence and retribution, argued J. Scott Dutcher, in light of the significant economic gain white-collar crime can produce.[96] Mary Kreiner Ramirez stated, "The dual purposes of retribution and deterrence support longer terms of imprisonment" to account for "the nefarious nature of economic crime."[97]

The Guidelines' lack of concrete direction and the swirling policies and motivations for punishing securities fraud are the setting for the two approaches to loss calculation created by the Ninth Circuit and the Second and Fifth Circuits.

III. Loss Calculation

The circuits' split centers on ascertaining the loss that defendants cause, and the different approaches stem from a nuanced distinction in classifying a defendant's culpability for securities fraud. Securities fraud is not a simple crime because multiple overlapping factors constantly influence the exchanges on which it occurs.[98] Further complicating the courts' handling of securities fraud is the courts' reliance on common law fraud principles to fill in the broad statutory prohibitions.[99] As securities transactions have become more complicated and nonparties have become liable, courts have grappled with sorting out the damage from fraud and the losses caused by market fluctuations.[100]

The Supreme Court tackled this issue in *Dura Pharmaceuticals, Inc. v. Broudo*, which addresses appropriate theories of loss in the civil

93. Vollrath, *supra* note 13, at 1018.

94. United States v. Adelson, 441 F. Supp. 2d 506, 509 (S.D.N.Y. 2006).

95. Podgor, *supra* note 38, at 280.

96. Dutcher, *supra* note 39, at 1305.

97. Ramirez, *supra* note 70, at 408.

98. Jill E. Fisch, *Cause for Concern: Causation and Federal Securities Fraud,* 94 Iowa L. Rev. 811, 820 (2009).

99. *Id.* at 840; *see also* Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 341 (2005) ("The courts have implied from these statutes and Rule a private damages action, which resembles, but is not identical to, common-law tort actions for deceit and misrepresentation.").

100. *See* Fisch, *supra* note 98, at 820–21 (describing the courts' attempts to better define the causation requirement).

context.[101] This decision, its implications, and its rationales are the foundation of the Ninth, Second, and Fifth Circuits' different resolutions of this question.

A. *Dura Pharmaceuticals, Inc. v. Broudo*

Since 1946, courts have interpreted the Exchange Act to imply a private cause of action for plaintiffs who claim that defendants have injured them through fraud in the sales of securities.[102] Courts have used common law fraud elements as the foundation for securities fraud claims.[103] Plaintiffs must show (1) a material misrepresentation, (2) scienter, (3) a connection with a purchase or sale of a security, (4) reliance on the fraud to engage in the transaction, (5) economic harm, and (6) causation between the fraud and the loss the plaintiff sustained.[104] This last element requires that plaintiffs show that the fraud was a significant cause of the loss, not just that the fraud was the reason they bought the shares.[105] In *Dura Pharmaceuticals*, the Supreme Court considered whether the inflated-purchase-price theory was sufficient to plead economic harm and proximate causation in civil actions.[106]

1. The Decision

The plaintiffs alleged that Dura Pharmaceuticals ("Dura") had made two misrepresentations: first, about one drug's future profitability, and second, about the likelihood of FDA approval of another drug.[107] The plaintiffs bought shares in the company after these announcements.[108] When the first drug's profitability did not meet Dura's predictions, the share price dropped significantly.[109] Eight months later, Dura announced that the FDA had not approved the second drug, leading to another drop, but the share price recovered within a week.[110]

The plaintiffs filed a class action suit, using as the end date for identifying class members the drop in Dura's share price resulting from the announcement of the first drug's lower sales.[111] Because the class's end date preceded the second drop in the share prices, which resulted from FDA disapproval of the second drug, the plaintiffs could not allege

101. 544 U.S. at 340.

102. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975); Kardon v. Nat'l Gypsum Co., 69 F. Supp. 512, 514 (E.D. Pa. 1946).

103. *See Dura Pharm.*, 544 U.S. at 341.

104. *See id.* at 341–42.

105. *Id.*

106. *Id.*

107. *Id.* at 339.

108. *Id.*

109. *Id.*

110. *Id.*

111. Broudo v. Dura Pharm., Inc., 339 F.3d 933, 936 (9th Cir. 2003).

that their losses stemmed from the price's decline after that announcement.[112] Instead, the plaintiffs alleged that Dura's initial statement about the likelihood of the FDA approval, which inflated Dura's share price, was false.[113] They argued that they had suffered economic harm because they had relied on those false statements in purchasing shares at the inflated price.[114]

The Ninth Circuit agreed this was a plausible theory of economic harm because the plaintiffs had suffered injury by paying more for the shares than they were worth.[115] The court also agreed that pleading an inflated purchase price satisfied the loss-causation element because the misrepresentation caused the shares to be overvalued, which led to the plaintiffs' injury of paying more than the actual value of the shares.[116]

In a strongly worded opinion, the Supreme Court reversed, stating, "In our view, this statement of the law is wrong."[117] According to the Court, the inflated-price theory fails because at the time of the purchase, the buyer has not suffered a loss: she holds a share worth the price she paid.[118] An inflated purchase price "might mean a later loss" "after the truth makes its way into the marketplace."[119] But the Court cautioned that 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."[120]

In reversing the Ninth Circuit, the Court pointed to the policy justifications for a private cause of action for securities fraud.[121] Private enforcement serves to deter fraud by compensating shareholders for the economic harm they actually suffered—not by providing "investment insurance" for market reliability.[122] The Court noted that Congress intended relief for shareholders only where a plaintiff has met "'the burden of proving' that the defendant's misrepresentations 'caused the loss for which the plaintiff seeks to recover.'"[123] The Ninth Circuit's theory, by contrast, "would allow recovery where a misrepresentation

112. *Id.* at 940–41.
113. *Dura Pharm.*, 544 U.S. at 339.
114. *Id.* at 340.
115. *Broudo*, 339 F.3d at 938–39.
116. *Id.*
117. *Dura Pharm.*, 544 U.S. at 342.
118. *Id.*
119. *Id.* (emphasis removed).
120. *Id.* at 343.
121. *Id.* at 345.
122. *Id.*
123. *Id.* at 345–46 (quoting 15 U.S.C. § 78u-4(b)(4)).

leads to an inflated purchase price but nonetheless does not proximately cause any economic loss."[124]

2. Analyzing Dura Pharmaceuticals

Both the Ninth Circuit's and the Supreme Court's decisions began with discussions of the harm the shareholders had suffered, but disagreed about the nature of that harm.[125] The Ninth Circuit found that paying an overvalued share price was an injury. [126] The Supreme Court rejected that finding because in the market, the shares are worth the inflated price;[127] the shareholder could recover the price she paid by selling to another market participant who relied on the same misinformation.[128]

The rationale underlying the Supreme Court's decision assumes that the misrepresentation has fooled the entire market. A shareholder suffers no harm until the truth comes out and she is stuck with shares that have far less value because of the fraud. In the Court's view, the market is like a game of hot potato. Potatoes (shares) bounce between parties until the music stops—the truth gets out—and only the shareholder still holding the potato can recover. Of course, other factors may have changed the desirability of the shares, but those factors do not constitute damage from the fraud.

When the Court held that an inflated purchase price could not constitute economic harm, it also precluded plaintiffs from using the inflated-purchase-price theory to show loss causation.[129] The Court suggests that economic harm occurs when the truth reaches the market, and plaintiffs must show how the truth has harmed them.[130] Because of the delay in the injury, the plaintiffs have to separate non-fraudulent market factors from the loss caused by the fraud.[131]

In *Dura Pharmaceuticals*, the Court held only that the inflated-price theory could not be used to plead economic harm or loss causation,[132] but the Court's reasoning has had significant impact in lower courts. Lower courts have interpreted *Dura Pharmaceuticals* to require that in order to show economic harm, plaintiffs must allege that the truth was revealed to the market.[133] Lower courts have also required analyses distinguishing

124. *Id*. at 346.

125. *Compare id.* at 342, *with* Broudo v. Dura Pharm., Inc., 339 F.3d 933, 938–39 (9th Cir. 2003).

126. *See Broudo*, 339 F.3d at 939.

127. *See Dura Pharm.*, 544 U.S. at 342.

128. *Id.*

129. *Id.* at 343–44.

130. *Id.* at 343.

131. *Id.*

132. *Id.* at 346 ("In sum, we find the Ninth Circuit's approach inconsistent with the law's requirement that a plaintiff prove that the defendant's misrepresentation (or other fraudulent conduct) proximately caused the plaintiff's economic loss. We need not, and do not, consider other proximate cause or loss-related questions.").

133. *See, e.g.*, Lormand v. US Unwired, Inc., 565 F.3d 228, 257–58 (5th Cir. 2009) (holding that the

between harm caused by the fraud and harm caused by other factors in order to satisfy the loss-causation element.[134]

The circuits have been grappling with reconciling *Dura Pharmaceuticals*' strict rules for civil loss with the expansive criminal sentencing regime.[135] The split created by the Ninth Circuit reflects two competing interpretations of *Dura Pharmaceuticals*' holding negating the use of the inflated-price theory, which in turn stem from two approaches to the differing culpabilities of civil and criminal liability.

B. The Second and Fifth Circuits' Adoptions of *Dura Pharmaceuticals*

In the aftermath of the *Dura Pharmaceuticals* decision, the Second and Fifth Circuits both held that the strict civil loss calculation standard it suggested also should apply to criminal sentencing.

1. The Decisions

In 2005, the Fifth Circuit heard *United States v. Olis,* an appeal from the conviction of Jamie Olis, a tax lawyer at Dynegy Corporation, who had engaged in a scheme to increase the appearance of Dynegy's earnings.[136] The SEC uncovered the scheme and forced Dynegy to restate its earnings.[137] The SEC also required Dynegy to publicize the SEC's investigation.[138] Dynergy's share prices dropped precipitously soon after.[139]

Olis received a 292-month sentence for his conviction.[140] His enhanced sentence resulted from the district court's finding that the scheme caused a loss of $105 million to the University of California Retirement System.[141] The loss calculation added twenty-six levels to his base offense level.[142] Combined with other enhancements, Olis' final

loss had to be caused by the "leaking out of relevant or related truth"); Glaser v. Enzo Biochem, Inc., 464 F.3d 474, 479 (4th Cir. 2006) (noting that the drop in price occurring before the alleged fraud had been disclosed could not have been caused by the fraud).

134. *See, e.g.*, *In re* Williams Sec. Litig. WCG Subclass, 558 F.3d 1130, 1139–40 (10th Cir. 2009) (finding that the expert's failure to account for other market forces in determining loss made the determination run afoul of *Dura Pharmaceuticals*); Ray v. Citigroup Global Mkts., Inc., 482 F.3d 991, 995 (7th Cir. 2007) (finding the plaintiffs' failure to separate the loss caused by fraud from the loss caused by the overall market decline insufficient to meet *Dura Pharmaceuticals*' requirements).

135. Besides *Olis*, *Rutkoske*, and *Berger*, the Tenth Circuit recently considered *Dura Pharmaceuticals*' applicability in the insider-trading context in United States v. Nacchio, 573 F.3d 1062, 1075 (10th Cir. 2009).

136. United States v. Olis, 429 F.3d 540, 541–42 (5th Cir. 2005).

137. *Id.*

138. *Id.* at 542.

139. *Id.*

140. *Id.*

141. *Id.*

142. *Id.* at 543.

offense level was forty, allowing for a range of 292 to 365 months.[143] Olis appealed, arguing that the loss calculation was a constitutional violation under *Booker* because his sentence was dramatically increased based on findings other than those made by the jury.[144]

The Fifth Circuit agreed that the district court failed to meet *Booker*'s requirement that lower courts "'consider' the guidelines before issuing a 'reasonable' sentence."[145] In particular, the Fifth Circuit found the district court's method of loss calculation problematic.[146] Instead of using the actual loss estimate required by the Guidelines, the district court used the university's loss as shorthand for the losses Olis caused.[147] The Fifth Circuit opined that the district court's method "overemphasized [its] discretion as factfinder at the expense of economic analysis."[148] The court found that though the Guidelines require only a "reasonable estimate of loss," they require the calculation to account only for the loss the defendant caused.[149]

Noting that "the civil damage measure should be the backdrop for criminal responsibility," the court found that *Dura Pharmaceuticals* provided a model for civil loss calculation that was "attuned to stock market complexities."[150] Under that model, "there is no loss attributable to a misrepresentation unless and until the truth is subsequently revealed and the price of the stock accordingly declines."[151] Looking to *Dura Pharmaceuticals*, the Fifth Circuit outlined the proper standard for loss calculation as a method that eliminated the "extrinsic factors" affecting share price decline, thus uncovering the loss from the fraud.[152] Because the model requires courts to strip away the effects of other market forces driving the price down, the Fifth Circuit found that the civil standard more accurately uncovers "actual loss" for the Guidelines.[153]

Finding that the district court's heuristic use of the university's loss failed to account for "extrinsic factors" acting on the shares, the Fifth Circuit held that the district court's loss calculation was unreasonable.[154] Olis' expert had testified that a decline in the market had paralleled Dynegy's share decline, and that the stock had begun dropping before news of the fraud had reached the market.[155] His report raised the

143. *Id.*
144. *Id.*
145. *Id.* at 544 (quoting United States v. Booker, 543 U.S. 220, 259 (2005)).
146. *Id.* at 548.
147. *Id.*
148. *Id.* at 545–48.
149. *Id.* at 545, 548.
150. *Id.* at 546.
151. *Id.*
152. *Id.* at 548–49.
153. *Id.*
154. *Id.* at 548.
155. *Id.*

possibility that other forces had led to Dynegy's share drop, and that "attributing to Olis the entire stock market decline suffered by one large or multiple small shareholders . . . would greatly overstate his personal criminal culpability."[156] Based on this report, the Fifth Circuit vacated the sentence and ordered resentencing.[157]

In *United States v. Rutkoske*, the Second Circuit also adopted *Dura Pharmaceuticals*' reasoning for criminal sentencing.[158] The court considered an appeal by David Rutkoske from his conviction and sentencing for securities fraud.[159] Rutkoske was a broker who participated in a scheme to inflate the share price of a gambling corporation.[160] He and his brokers spread several pieces of misinformation in their attempts to generate demand for the shares, and eventually the share price plummeted, with investors losing about $12 million.[161] In calculating the loss, the district court followed the recommendation of an expert witness, who used the value of the stock three months after the conspiracy ended as a benchmark against which to determine the loss in value.[162] The calculation was not tied to the disclosure of the fraud to the market.[163]

Having previously expressed uneasiness with the severity of the sentencing in *United States v. Ebbers*, the Second Circuit reiterated that "[m]any factors may cause a decline in share price between the time of the fraud and the revelation of the fraud. In such cases, '[l]osses from causes other than the fraud must be excluded from the loss calculation.'"[164] Citing approvingly to *Olis*, the Second Circuit held that the Supreme Court's reasoning in *Dura Pharmaceuticals* applied in loss calculations for criminal sentencing.[165] Using that reasoning, the court suggested that establishing a loss for purposes of the loss calculation under the Guidelines requires that the fraud is disclosed to the market.[166] The court instructed lower courts to separate the loss from fraud from "other factors" contributing to the decline in share prices.[167] The Second Circuit provided further guidance, noting, "Normally, expert opinion and some consideration of the market in general and relevant segments in particular will enable a sentencing judge to approximate the extent of loss caused by a defendant's fraud."[168]

156. *Id.*
157. *Id.* at 549.
158. 506 F.3d 170, 179 (2d Cir. 2007).
159. *Id.* at 171.
160. *Id.* at 173.
161. *Id.*
162. *Id.* at 180.
163. *Id.*
164. *Id.* at 179 (citation omitted) (quoting United States v. Ebbers, 458 F.3d 110, 128 (2d Cir. 2006)).
165. *Id.*
166. *Id.* at 179–80.
167. *See id.*
168. *Id.* at 180.

The Second Circuit found that the district court's method insufficiently accounted for the other factors affecting the drop in share price.[169] The expert witness's calculation attributed to Rutkoske the entire share price decline.[170] The government's argument that the market was "thin," and therefore that the price drop was caused by the fraud, did not convince the court.[171] The district court's failure to tie its calculation to the fraud's disclosure to the market or to account for other market forces affecting the drop in the share price required resentencing.[172]

2. *Analyzing* United States v. Rutkoske *and* United States v. Olis

In adopting *Dura Pharmaceuticals*, both courts focused on the harm to shareholders as the basis of the defendant's culpability. The primary focus in *Dura Pharmaceuticals* is the actual pecuniary loss to the shareholders,[173] and the circuit courts in *Rutkoske* and *Olis* similarly focused on the loss shareholders sustained.[174] The courts assumed that the harm for which defendants are liable in the civil context overlaps, or is even identical to, the harm for which defendants are culpable in the criminal context. As *Dura Pharmaceuticals* suggests, in the civil context, defendants are liable for the losses shareholders sustain after word of the fraud reaches the market and has affected the shares' value.[175] *Rutkoske* and *Olis* adopted this reasoning to find that a criminal defendant's culpability rests on the loss in value shareholders sustain.[176]

Conflating the loss in the civil context with the loss in the criminal context is the premise that drives both courts' decisions. The Fifth Circuit justifies this premise by noting the "civil damage measure . . . furnishes the standard of compensable injury for securities fraud victims and . . . is attuned to stock market complexities."[177] The Second Circuit noted that it 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."[178]

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169. *Id.*

170. *Id.* at 178.

171. *Id.* at 180.

172. *Id.*

173. Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 342 (2005).

174. *See Rutkoske*, 506 F.3d at 179; United States v. Olis, 429 F.3d 540, 546 (5th Cir. 2005).

175. *See* 544 U.S. at 343–44.

176. *See Rutkoske*, 506 F.3d at 179 (noting that the calculation centers on "shareholders' losses"); *Olis*, 429 F.3d at 546 (citing *Dura Pharmaceuticals* in describing the loss calculation requirements for sentencing).

177. *Olis*, 429 F.3d at 546.

178. *Rutkoske*, 506 F.3d at 179.

The decisions also import the loss-causation reasoning of *Dura Pharmaceuticals* into the assessment of loss under the Guidelines.[179] The decisions instruct lower courts to account for other market forces in their analyses of losses for sentencing.[180] The adoption of this reasoning reveals a concern with the incongruity between long sentences and the culpability of the defendants.[181]

Interestingly, the Guidelines use loss as a way to correct a tendency to under-sentence white-collar criminals in comparison to their blue-collar counterparts.[182] Using the amount of loss as the primary enhancement appeared to render objective sentences reflecting the defendant's culpability.[183] As the Second Circuit noted in *Ebbers*, however, the resulting sentences in the securities fraud context are often longer than sentences for violent crimes.[184] Because a corporation may have billions of shares, a small drop in share price very quickly results in hundreds of millions of dollars in loss.[185]

By adopting the *Dura Pharmaceuticals* reasoning, the Second and Fifth Circuits attempted a more equitable correlation between the crime and the punishment. The decisions reflect a belief, shared in *Dura Pharmaceuticals*, that lower courts can isolate the harm caused by a disclosed fraud by removing other factors affecting share price until they have exposed the decline caused by the fraud.[186] The courts recognize the difficulty in this proposition, noting that such isolation is neither easy nor exact.[187] And yet, making the attempt to isolate the harm from the fraud

179. *Id.* at 179; *Olis*, 429 F.3d at 546.

180. *See Rutkoske*, 506 F.3d at 179; *Olis*, 429 F.3d at 548–49.

181. *See Rutkoske*, 506 F.3d at 179 ("[W]e acknowledged the complexities inherent in calculating the loss amount but emphasized that '[t]he loss must be the result of the fraud.' Many factors may cause a decline in share price between the time of the fraud and the revelation of the fraud. In such cases, '[l]osses from causes other than the fraud must be excluded from the loss calculation.'" (quoting United States v. Ebbers, 458 F.3d 110, 128 (2d Cir. 2006))); *Olis*, 429 F.3d at 547 ("Sentencing decisions in these cases acknowledge that because a company's stock price is affected before and after the fraud, by numerous extrinsic market influences as well as the soundness of other business decisions by the company, the calculation of loss attributable to securities fraud requires careful analysis.").

182. Vollrath, *supra* note 13, at 1007.

183. *See id.* at 1007–08.

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

185. *See id.*

186. *Rutkoske*, 506 F.3d at 180 ("Normally, expert opinion and some consideration of the market in general and relevant segments in particular will enable a sentencing judge to approximate the extent of loss caused by a defendant's fraud."); *Olis*, 429 F.3d at 546 ("District courts must take a 'realistic, economic approach to determine what losses the defendant truly caused or intended to cause.'" (quoting United States v. W. Coast Aluminum Heat Treating Co., 265 F.3d 986, 991 (9th Cir. 2001))).

187. *Rutkoske*, 506 F.3d at 179 ("Determining the extent to which a defendant's fraud, as distinguished from market or other forces, caused shareholders' losses inevitably cannot be an exact science. The Guidelines' allowance of a 'reasonable estimate' of loss remains pertinent." (citation omitted)); *Olis*, 429 F.3d at 547 ("[G]iven the time and evidentiary constraints on the sentencing process, the methods adopted in these cases are necessarily less exact than the measure of damage applicable in civil securities litigation.").

seems to ease the courts' concerns about the disproportionality between culpability and punishment that can result from the Guidelines' loss emphasis.[188]

Still, employing the *Dura Pharmaceuticals*' loss calculation reasoning does not prevent long sentences for defendants. As a hypothetical example, consider John, corporate officer for Acme Corporation, who issues an earnings statement that materially misrepresents Acme's earnings. The next quarter, John's over-optimism comes to light and he restates the earnings, admitting simultaneously that he engaged in fraud. Assuming the market is stable during that period, any change in the price results exclusively from the fraud.

Upon disclosure, the share price drops only twenty cents, but because Acme has 1 billion shares,[189] the "loss" from the fraud is $200 million and adds twenty-eight levels to John's sentence.[190] Shareholder harm from the drop in the price depends on the number of shares each shareholder owns: A shareholder owning twenty percent of the shares suffers a $40 million loss, whereas a shareholder owning one share loses only twenty cents. Under the Guidelines and the Second and Fifth Circuit's holdings, John's sentence reflects the entire decline.

Realistically, therefore, the civil loss calculation remains beholden to the Guidelines' stiff penalties for large losses. Nevertheless, the application of the civil loss standard does imply that there is a closer connection between the fraud and the loss for which the defendant is being punished.

C. The Ninth Circuit's Departure

In *United States v. Berger*, the Ninth Circuit faced an issue similar to those dealt with by the Fifth and Second Circuits but declined to adopt the *Dura Pharmaceuticals* reasoning for criminal sentencing.[191] The Ninth Circuit's decision reflects a different understanding of the culpability inherent in securities fraud.

1. The Decision

The Ninth Circuit heard an appeal from Richard Berger, who protested his sentencing for securities fraud. Berger had continuously

188. *Rutkoske*, 506 F.3d at 179 ("[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."); *Olis*, 429 F.3d at 546 (noting that the civil damages loss calculation is appropriate in the criminal context because it is "attuned to stock market complexities").

189. This is not an unrealistic number. The Walt Disney Company, for example, has approximately 1.86 billion shares. *The Walt Disney Co. (DIS)*, Street, www.thestreet.com/quote/DIS.html (last visited Dec. 23, 2011).

190. *See* U.S. Sentencing Guidelines Manual § 2B1.1(b)(1) (2010).

191. 587 F.3d 1038, 1043 (9th Cir. 2009).

misrepresented his company's financial health from its initial public offering through its eventual demise.[192] He failed to report the extent of the company's earnings and liabilities, instead stating in disclosures to the SEC that the company had sufficient earnings to cover its loans.[193] In fact, the company was in default.[194]

An audit uncovering the accounting irregularities forced the company to restate its earnings, leading to a sharp decline in its share price.[195] The share price declined below NASDAQ's requirements, resulting in the delisting of the company's shares.[196] News of the accounting irregularities and the securities fraud did not become public until after the company had already delisted the shares.[197] The district court used examples of other companies with publicized accounting irregularities to estimate the loss from the unpublicized fraud in this case.[198] Berger appealed, arguing that the district court should have applied *Dura Pharmaceuticals'* economic harm and causation reasoning in its calculation.[199]

While finding the district court's calculation flawed, the Ninth Circuit disagreed that *Dura Pharmaceuticals* reasoning regarding shareholder losses applied to criminal sentencing loss calculations.[200] In its explicit departure from the Second Circuit's holding, the court reasoned *Dura Pharmaceuticals* was inapplicable because "the primary policy rationale . . . for proscribing overvaluation as a valid measure of loss does not apply in a criminal sanctions context."[201]

The Ninth Circuit asserted that the foundation of common law fraud underlying the *Dura Pharmaceuticals*' requirement referred only to the plaintiff's burden to show loss.[202] This requirement was distinct from the criminal context's concern with "the amount of loss *caused*, i.e., the harm that society as a whole suffered from the defendant's fraud."[203] The court argued that an inflated purchase price represents "aggregate loss to society . . . even if various individual victims' respective losses cannot be precisely determined or linked to the fraud."[204]

Furthermore, the court found the application of *Dura Pharmaceuticals*' civil rule to criminal sentencing would "clash with the

192. *Id.* at 1040–41.
193. *Id.* at 1040.
194. *Id.*
195. *Id.*
196. *Id.* at 1040–41.
197. *Id.* at 1041.
198. *Id.*
199. *Id.* at 1042.
200. *Id.* at 1043.
201. *Id.*
202. *Id.* at 1044.
203. *Id.*
204. *Id.*

parallel principles in the Sentencing Guidelines, which have persuasive value in federal courts."[205] Looking to the 1995 version of the Guidelines, the Ninth Circuit noted the endorsement of overvaluation as a method of calculating loss from fraud.[206] The court found that application of *Dura Pharmaceuticals*' reasoning, prohibiting an inflated purchase price as a method of determining loss, would run directly counter to that endorsement.[207] Moreover, the court opined that the Guidelines required only a "reasonable estimate of the loss" and offered broad directions about calculation.[208] The court concluded that these directions from the 1995 version allowed, if not condoned, overvaluation as an appropriate method for calculating loss.[209]

Though the court rejected applying *Dura Pharmaceuticals*' loss reasoning, it nevertheless found the district court's calculation problematic.[210] The district court did not determine the extent to which Berger's fraud had overvalued the stock and what loss, in the form of overvaluation, his victims had sustained.[211] Instead, the district court presumed the loss occurred and then used similar companies' share price declines to estimate the amount of decline attributable to Berger's fraud.[212] The district court's calculation was an attempt to figure out the percentage of the drop in share price caused by the fraud, which was impossible because the fraud did not become public until after the company delisted its shares.[213] The Ninth Circuit remanded, requiring the district court to determine the inflation in the value of the shares caused by the fraud in order to determine the loss.[214]

2. *Analyzing* United States v. Berger

In contrast to the Second and Fifth Circuits' holdings, the Ninth Circuit's decision rests on the proposition that harm occurs when the substance of the fraud enters the market, rather than when the truth becomes known.[215]

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205. *Id.* at 1043.

206. *Id.* at 1045. The 1995 version of the Guidelines is the applicable standard because Berger's fraud ended before the 2001 amendment of the Guidelines. *Id.* at 1044.

207. *Id.*

208. *Id.* at 1045.

209. *Id.*

210. *Id.*

211. *Id.* at 1046.

212. *Id.*

213. *Id.*

214. *Id.*

215. *See id.* at 1044 ("[W]here the value of securities have been inflated by a defendant's fraud, the defendant may have caused aggregate loss to society in the amount of the fraud-induced overvaluation, even if various individual victims' respective losses cannot be precisely determined or linked to the fraud."); *see also* Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 340 (2005); Broudo v. Dura Pharm., Inc., 339 F.3d 933, 938 (9th Cir. 2003) ("[L]oss causation does not require pleading a stock

The Ninth Circuit noted that the difference between the civil and criminal contexts lies in the policy justifications for each. Civil litigation is an attempt by the shareholder to recover damages from the fraud.[216] The individualized harm to the shareholder, according to the Supreme Court, occurs only when the truth becomes public.[217] The Ninth Circuit distinguished the civil harm to individual shareholders from the public harm resulting from the crime of securities fraud.[218] The court's holding suggests the harm is the overall deception of the market from the fraud.[219]

Berger differentiated culpability for acting deceitfully from culpability for shareholder losses resulting from the deceit. The facts of *Berger* highlight the distinction. Berger's fraud did not become public before the shares were delisted, yet he was culpable for broadcasting fraudulent information to the market and inflating the share prices.[220] The Ninth Circuit's holding reflects a belief that there is an important difference between civil liability, where the focus is compensation, and criminal liability, where the focus is punishment.[221]

The reasoning in *Berger* is not without issue. First, the Ninth Circuit relies on the 1995 version of the Guidelines to find that Congress endorsed overvaluation as a method of calculating loss.[222] However, in the 2001 amendment of the Guidelines, the Sentencing Commission dropped the overvaluation preference, stating instead that a "reduction that resulted from the offense in the value of equity securities or other corporate assets" is a factor in determining loss.[223] Without an overvaluation preference in the guidelines, the Ninth Circuit's reasoning for allowing price inflation to show loss is less convincing.

In addition, critics of *Berger* argue the decision creates a lower standard of loss calculation than in the civil litigation context, where *Dura Pharmaceuticals* binds courts.[224] As one critic noted, *Berger* "will

price drop following a corrective disclosure or otherwise. It merely requires pleading that the price at the time of purchase was overstated and sufficient identification of the cause.").

216. *Berger*, 587 F.3d at 1043–44.

217. *Dura Pharm.*, 544 U.S. at 343–44.

218. *Berger*, 587 F.3d at 1044 ("[I]n a private civil fraud action, a court gauges loss from the perspective of the plaintiff-victim . . . . In criminal sentencing, however, a court gauges the amount of loss *caused* . . . .").

219. *Id.* ("Criminal sentencing [considers] the harm that society as a whole suffered from the defendant's fraud.").

220. *See id.* at 1041.

221. *See* Cenco Inc. v. Seidman & Seidman, 686 F.2d 449, 455 (7th Cir. 1982) ("[The] objectives of tort liability . . . . are to compensate the victims of wrongdoing and to deter future wrongdoing."); Note, *Victim Restitution in the Criminal Process: A Procedural Analysis*, 97 HARV. L. REV. 931, 936 (1984) (noting that criminal law is concerned with societal harm as well as harm to individual victims).

222. *Berger*, 587 F.3d at 1045.

223. U.S. SENTENCING GUIDELINES MANUAL § 2B1.1 cmt. n.3(C)(v) (2010); *see also* Ramirez, *supra* note 70, at 377 (describing the 2001 amendments).

224. James A. Jones II, Note, *United States v. Berger: The Rejection of Civil Loss Causation*

cause further inflated sentences in securities fraud cases in which defendants are already subject to disproportionately high loss tables and multiple, redundant upward adjustments."[225] Another noted that the Ninth Circuit's decision will affect "pretrial negotiations among prosecutors and criminal securities fraud defendants" because defendants could face "a potentially greater sentence based on the sentencing court's calculation of loss under *Berger*."[226]

But these criticisms fail to take account of the distinction in *Dura Pharmaceuticals* between economic harm and loss causation.[227] In *Berger*, the Ninth Circuit rejected only the Supreme Court's reasoning that for harm or loss to occur there must be disclosure of the fraud to the market.[228] It implicitly accepted the Court's reasoning that loss must be the result of the fraud, noting that whether loss stems from the disclosure of the fraud or from price inflation, it must be the product of the fraud.[229] *Berger* does not permit district courts to attribute loss to the defendant without showing a link between the loss and the fraud; in fact, in *Berger*, the district court's failure to make that link caused the Ninth Circuit to remand the case.[230]

D. Reaching a Workable Loss Calculation

A workable loss calculation must address the policies underlying the regime of criminal sentencing, namely that of effective deterrence and fair punishment. The Ninth Circuit's approach, with certain modifications, more closely approaches this balance.

Loss calculation should focus on the culpability of the defendant rather than on the individual harm. Disclosure of the fraud to the market should not be a requirement in assessing the damage caused by the defendant. Criminalizing securities fraud reflects society's intolerance for both the inefficiencies caused by the fraud and for the harm individuals suffer from the fraud.[231] Private civil litigation suitably provides

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Principles in Connection with Criminal Securities Fraud, 6 Wash. J.L. Tech. & Arts 273, 283 (2011); A. Jeff Ifrah & Rachel Hirsch, *Circuits Split Over Securities Fraud Sentencing*, Ifrah Law (July 19, 2010), http://www.ifrahlaw.com/circuits-split-over-securities-fraud-sentencing/; Gregory L. Poe, *Sentencing in Fraud Cases Involving Shareholder Loss*, Fed. Criminal Practice Blog (Dec. 31, 2009), http://blog.gpoelaw.com/sentencing-in-fraud-cases-involving-shareholder-loss/.

225. Ifrah & Hirsch, *supra* note 224.

226. Jones, *supra* note 224, at 283.

227. *See* Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 346 (2005) (noting that the inflated-purchase-price theory would eliminate both the "economic loss" and "proximate causation" elements from a securities fraud cause of action).

228. United States v. Berger, 587 F.3d 1038, 1045 (9th Cir. 2009) ("[W]e decline to require, in finding facts relevant to sentencing, a showing that 'share price fell significantly after the truth became known.'" (quoting *Dura Pharm.*, 544 U.S. at 347)).

229. *Id.* at 1043 (noting the requirement that the loss be caused by the defendant's fraud).

230. *Id.* at 1046.

231. *See, e.g.*, *Message from the President—Regulation of Securities Exchanges*, 78 Cong. Rec.

shareholders with the opportunity to recover for their individual harm. In contrast, criminal liability reflects the government's attempt to regulate the market broadly and to deter behavior that impacts the market beyond the harm sustained by shareholders of the affected company.[232]

In a situation like that in *Berger*, where the fraud never becomes public, a defendant unduly benefits under *Dura Pharmaceuticals* by continuing to hide the fraud. For example, under *Dura Pharmaceuticals*, Berger might have escaped any loss enhancement for his actions. He lied about the company's profitability and liabilities, but the truth—that the company was never profitable and had substantial debt—did not come to light until after the shares were delisted.[233] The drop in share price preceding the delisting resulted from the company's current unprofitable state, not from the knowledge that the company was *never* profitable.

Under a *Dura Pharmaceuticals* analysis, such losses are not the result of the fraud; they are the result of the current condition of the company. This result is incongruous with Berger's culpability. He is guilty because he misrepresented the state of his company, which led to a market-wide deception about the appropriate value of the company's shares. Returning to the "hot potato" metaphor, Berger is responsible for creating the game in the first place: he started passing the potato and he started playing the music. Adopting the *Dura Pharmaceuticals* economic-loss reasoning means he escapes liability because people dropped the potato before he stopped the music. As Miriam Baer has noted, corporate officials already benefit from continuing the fraud; requiring *Dura Pharmaceuticals* to apply in every situation of loss calculation would increase that incentive.[234]

A price-inflation theory allows courts to discount the mitigating effects on the share-price decline of the publicity surrounding the discovery of the fraud.[235] Information about the investigation may cause share-price decline before the truth itself becomes public.[236] The decline after the broadcasting of the fraud may be much less than the overall

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2264–72 (1934), *reprinted in* 4 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 & SECURITIES EXCHANGE ACT OF 1934, at 2264 (2001) ("I therefore recommend to the Congress the enactment of legislation providing for the regulation by the Federal Government of the operations of exchanges dealing in securities and commodities for the protection of investors, for the safeguarding of values, and, so far as it may be possible, for the elimination of unnecessary, unwise, and destructive speculation.").

232. *See* 15 U.S.C. § 78b (2010); *cf.* Prentice, *supra* note 42, at 830 ("[S]tringent securities laws shape morals and behavior.").

233. *Berger*, 587 F.3d at 1040–41.

234. *See* Baer, *supra* note 37, at 1362 ("[*Dura Pharmaceuticals*] unwittingly perpetuates the corporate executive's naïve hope that better information will surface in the future and thereby counteract the fraud.").

235. Fisch, *supra* note 98, at 848–49.

236. *See id.*

drop in the share price or than the inflation of the value of the shares because of the fraud.[237] Under *Dura Pharmaceuticals*, district courts remove these "extrinsic factors" from their calculation of the loss.[238] This process incentivizes defendants to time disclosure of the fraud until the prices have dropped independently, either from the investigation or from outside market forces.[239]

The Commission should amend the Guidelines to again endorse overvaluation as a method of calculating loss. This step would more closely align the Guidelines with the culpability of white-collar defendants and would provide greater guidance to courts in assessing loss. Alternatively, the Supreme Court should address the circuits' dispute by allowing price inflation as a means of determining loss under the guidelines.

While the Ninth Circuit's reasoning more accurately accounts for the government's interests in regulating the markets, *Berger* fails to provide a sufficiently rigorous framework for calculating loss under a price-inflation theory. Whether the Commission amends the Guidelines or the Supreme Court accepts the price-inflation theory, courts should explicitly adopt the causation reasoning in *Dura Pharmaceuticals* and require expert testimony and examination of the inflated purchase-price numbers by district courts. Nevertheless, a price-inflation theory actually parallels modern finance theory more closely than the *Dura Pharmaceuticals* reasoning and may prove to be more workable.[240]

Even if the Commission fails to amend the Guidelines, a price-inflation theory works within the current Guidelines. The Guidelines allow courts to use gain as a determinate of loss where "there is a loss but it reasonably cannot be determined."[241] If the market does not discover the truth while shares remain on the exchange, it is nearly impossible to determine the reduction in the shares' value that resulted from the fraud. In those situations, price inflation is a valid method for calculating the gain a defendant earned from his fraud.

The Ninth Circuit's reasoning, even if modified and rigorously examined, may result in long sentences for white-collar criminals. The Guidelines, as the product of Congress's powers, reflect a policy decision to assign securities fraud defendants lengthy sentences based on their culpability.[242] The Ninth Circuit's reasoning more closely aligns with that policy.

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237. *Id.*
238. *See supra* note 134.
239. Fisch, *supra* note 98, at 852.
240. *Id.* at 845.
241. U.S. SENTENCING GUIDELINES MANUAL § 2B1.1 cmt. n.3(B) (2010).
242. *See supra* note 85 and accompanying text; *see also* Vollrath, *supra* note 13, at 1020–23.

CONCLUSION

Congress passed the Exchange Act over eighty years ago with the intent of providing reliable markets for the American population. To ensure that benefit, Congress has authorized criminal liability for particularly culpable behavior in violations of the Act. Securities fraud destabilizes markets and injures individual shareholders through the spread of false information, and Congress has signaled the seriousness of committing securities fraud by providing a twenty-year statutory maximum sentence.

The Ninth Circuit's decision in *Berger* accords more closely with Congress's intentions. By targeting the culpable behavior rather than individual loss, the Ninth Circuit has closed a loophole under the Guidelines: Defendants cannot hide their fraudulent behavior and fortuitously disclose it only when the shares have declined from other causes. Combined with a rigorous standard for causation, price inflation is an appropriate means to establish loss under the Guidelines. The Commission should amend the Guidelines to reflect that fact.