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11th Circ. Ruling May Affect Criminal Securities Fraud Cases

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The climactic event in most white collar criminal sentencing proceedings is the calculation of the loss resulting from the offense, given that this number is typically the primary driver of the length a federal prison sentence for fraud under the U.S. sentencing guidelines.[1]

This is especially so in fraud-on-the-market type criminal securities fraud cases. In these cases, public company executives are alleged to have defrauded a company's shareholders by falsely inflating the company's profits and disguising its true financial condition in financial statements published to shareholders and filed with the U.S. Securities and Exchange Commission such that there is a presumption that the misstatements were automatically incorporated into the company's stock price and all of the company's shareholders actually relied on them in making their investment decisions. This is known as the Basic presumption or the "fraud-on-the-market" presumption.[2] The inevitable decline in stock price once the fraud is revealed to the public is viewed as a proxy for the amount by which the stock price was artificially inflated by the fraud and, thus, the amount by which the shareholders were harmed. Spread over millions or even billions of outstanding shares, a drop of only a few dollars per share can result in astronomical loss estimates that generate advisory sentencing ranges of decades or even life imprisonment for public company executives.[3]

To address concerns that such estimates might overstate the defendant's culpability in these cases, the U.S. Sentencing Commission has tinkered with the commentary to the relevant sentencing guidelines over the years.[4] Further, in an attempt to limit their exposure, white collar defendants have tried to import into securities fraud sentencing proceedings the loss causation principles used to limit plaintiffs' damages in federal civil securities fraud cases.

Specifically, defendants have argued that the loss causation principles of Dura Pharmaceuticals Inc. v. Broudo, 544 U.S. 336 (2005), a federal civil securities fraud decision, should apply to the calculation of losses in criminal securities fraud cases. These efforts to import Dura into criminal cases have been met with mixed results over the past decade and, until this month, were the subject of a narrow 4-3 federal circuit split, the Third, Fourth, Sixth and Ninth Circuits having rejected the argument,[5] and the Second, Fifth and Tenth Circuits having accepted it.[6]

In a Jan. 18, 2017, published decision, United States v. Stein, No. 14-15621, the Eleventh Circuit became the latest court of appeals to reject the application of Dura to loss and restitution calculations in criminal securities fraud cases.[7] Although the ruling was buried in a footnote on the 40th page of a 47-page decision, with little fanfare or analysis, the decision could hinder efforts to limit loss estimates in fraud-on-the-market criminal securities fraud cases.[8] This is because the case cemented a firm 5-3 majority on this issue that will undoubtedly weigh heavily on sentencing judges and appellate judges who will be confronted with this issue in the four remaining circuits that have yet to address it (the First, Seventh, Eighth and D.C. Circuits).

Background — Dura

In Dura Pharmaceuticals Inc. v. Broudo, 544 U.S. 336 (2005), the U.S. Supreme Court held that, to prove a federal civil securities fraud claim, plaintiffs cannot simply show that they purchased stock at an artificially inflated price, but must show that they purchased stock that subsequently declined in value as a result of the disclosure of the facts underlying the fraud (i.e., that they actually sustained a loss that was caused by the actual misstatement).[9] The Dura court also noted that there are “a tangle of factors affecting [stock] price,” and that other market or industry factors, such as “changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events, [could] taken separately or together account for some or all of [the] lower price.”[10]

Dura invigorated “loss causation” litigation in civil securities fraud cases aimed at limiting damages calculations. This includes litigation over the extent to which plaintiffs must disentangle the effects of the alleged fraud from those of unrelated market forces in calculating damages;[11] and what constitutes a legally cognizable “corrective disclosure” that would allow for the measurement of a decline in share value (i.e., at what point the facts underlying the fraud have been fully revealed to the market and thus incorporated into the stock price).[12]

The Application of Dura to Loss Calculations in Criminal Securities Fraud Cases

After Stein, three circuits have applied Dura to the calculation of loss in criminal securities fraud cases, and five circuits have rejected it. Courts that have applied Dura have generally held that loss estimates overstate the defendant’s personal culpability where such estimates fail to subtract out losses caused by forces that were unrelated to the defendant’s scheme. For example, in United States v. Olis, 429 F.3d 540 (5th Cir. 2005), the Fifth Circuit reversed a securities fraud sentence that was based in large part on a single institutional investor’s $105 million loss, calculated by subtracting the share price following the revelation of the fraud from the original purchase price.[13] The Fifth Circuit observed that the loss estimate failed to account for decreases in stock price after the purchase but before the corrective disclosure, such as a failed bid to purchase another company and an overall decline in the issuer’s industry.[14]

In contrast, courts that have rejected Dura have generally held that unlike a civil securities fraud case, the object of which is to compensate an injured shareholder for a specific financial loss that the shareholder actually sustained, criminal securities fraud cases are aimed at punishing defendants for the aggregate harm caused by the crime to all shareholders even if individual losses cannot be determined with precision or linked to the fraud, and the sentencing guidelines do not mandate mathematical precision, but merely require the court to make a reasonable estimate of the loss.[15] Moreover, at least one of these courts specifically held that there is no requirement to disentangle or subtract out losses that may have resulted from other causes.[16]

The solid majority established by Stein should make it more difficult to use Dura to limit securities fraud loss calculations in sentencing proceedings outside of the Second, Fifth and Tenth Circuits. Further, practitioners should not expect the Supreme Court to resolve this split anytime soon, having declined to do so as recently as Nov. 28, 2016.[17] However, a careful reading of Stein and the relevant sentencing guidelines commentary suggests a way forward.

The Way Forward After Stein

First, in practically the same breath with which it rejected Dura, the Stein court also opined that if the defendant could show that a portion of the investor losses at issue was attributable to an intervening cause, and that cause was not reasonably foreseeable to the defendant, “the district court, to the extent possible, should approximate the effect of such intervening events and subtract this amount from its actual loss calculation.”[18] The Ninth Circuit made a similar observation despite rejecting the application of Dura to securities fraud loss calculations in United States v. Berger, 587 F.3d 1038 (9th Cir. 2009), noting that regardless of Dura’s applicability, the defendant should be held criminally responsible only for the harm that could be attributed to him.[19] These pronouncements suggest that although sentencing courts outside of the Second, Fifth and Tenth Circuits will not require the technical precision of Dura and its progeny, they may still entertain arguments for subtracting out losses that were clearly caused by other factors, if those losses can be reasonably approximated.

Second, in its Nov. 1, 2015, amendments to the sentencing guidelines, the Sentencing Commission restored flexibility to the calculation of loss in fraud-on-the-market securities fraud cases, providing that “in a case involving the fraudulent inflation or deflation in the value of a publicly traded security or commodity, the court in determining loss may use any method that is appropriate and practicable under the circumstances.”[20] The amended commentary apparently recognizes that there is no one-size-fits-all measure of loss in these cases, thus allowing judges, prosecutors, and defense counsel to be creative in fashioning the most appropriate calculation based on the facts of the case.

Third, despite a majority of circuit courts having rejected the application of Dura to the calculation of losses in criminal securities fraud cases, in little-noticed 2012 revisions to the relevant commentary (which survive today), the commission appears to have expressly endorsed the use of loss causation principles to evaluate the reasonableness of loss estimates in certain circumstances. While it did not mention Dura by name, the commission recited Dura’s “tangle of factors” affecting stock price virtually verbatim, and stated that it was appropriate to consider such factors in assessing the reasonableness of loss estimates, arguably incorporating Dura into the reasonableness analysis to be conducted pursuant to 18 U.S.C. § 3553(a).[21]

Accordingly, while Stein may make it more difficult for defendants to advance Dura arguments to limit loss calculations in fraud-on-the-market criminal securities fraud cases outside of the Second, Fifth and Tenth Circuits, various avenues for attacking and limiting astronomical loss estimates in such cases remain.

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[1] See U.S.S.G. § 2B1.1(b)(1)

[2] Basic Inc. v. Levinson, 485 U.S. 224, 247 (1988) (under the fraud-on-the-market theory, an investor's

reliance on a "public material misrepresentation[ ]" is presumed because "most publicly available information is reflected in market price[s].").

[3] In contrast, such estimates are less important to the sentencing of Ponzi scheme and pump-and-dump securities fraud cases, which typically involve far fewer victims and microcap or nanocap stocks with far lower trading volumes, making actual investor losses more easily ascertainable.

[4] See, e.g., U.S. Sentencing Commission, Amendments to the Sentencing Guidelines (Apr. 30, 2015) at 25, 31 (available at http://www.ussc.gov/sites/default/files/pdf/amendment-process/official-text amendments/20150430_Amendments_0.pdf.); U.S. Sentencing Commission, Proposed Amendments to the Sentencing Guidelines (Jan. 16, 2015) at 87-88 (available at http://www.ussc.gov/sites/default/files/pdf/amendment-process/reader-friendly-amendments/2015014-RFP-Amendments.pdf.).

[5] See United States v. Georgiou, 777 F.3d 125, 146 (3d Cir.), cert. denied, 136 S. Ct. 401 (2015); United States v. Rand, 835 F.3d 451, 469 (4th Cir.), cert denied, 196 L. Ed. 2d 408 (2016); United States v. Peppel, 707 F.3d 627, 644-45 (6th Cir. 2013); United States v. Berger, 587 F.3d 1038, 1044 (9th Cir. 2009).

[6] See United States v. Rutkoske, 506 F.3d 170, 179 (2d Cir. 2007); United States v. Olis, 429 F.3d 540, 526 (5th Cir. 2005); United States v. Nacchio, 573 F.3d 1062, 1078 (10th Cir. 2009).

[7] Stein Opinion at 40 n.20.

[8] Id.

[9] Dura Pharmaceuticals, Inc. v. Broudo, 544 U.S. 336, 344-45 (2005).

[10] Id. at 343.

[11] In re Flag Telecom Holdings, Ltd. Sec. Litig., 574 F.3d 29, 36 (2d Cir. 2009).

[12] See, e.g., Ryan v. Flowserve Corp., 444 F. Supp. 2d 718, 726-27 (N.D. Tex. 2006) (rejecting argument that disclosure must include a "fact-for-fact" correction of each fact allegedly misrepresented to qualify as a corrective disclosure).

[13] United States v. Olis, 429 F.3d at 548-49.

[14] Id.

[15] See, e.g., United States v. Berger, 587 F.3d at 1044.

[16] United States v. Poulsen, 655 F.3d 492, 514 (6th Cir. 2011).

[17] Rand, 196 L. Ed. 2d 408 (2016) (order denying petition for certiorari).

[18] Stein Opinion at 40.

[19] 587 F.3d at 1046.

[20] Application Note 3(F)(ix) to § 2B1.1(b)(2).

[21] Compare, U.S. Sentencing Commission, Amendments to the Sentencing Guidelines (Apr. 30, 2012) at 13 (available at http://www.ussc.gov/sites/default/files/pdf/amendment-process/reader-friendly-amendments/20120430_RF_Amendments.pdf), with, Dura, 544 U.S. at 343.