

TODD K. LESTER, tleston@navigant.com
 JEFFREY B. JENSEN, jeffrey.jensen@huschblackwell.com
 MATTHEW P. DIEHR, matthew.diehr@huschblackwell.com

Federal Sentencing For Economic Crimes – Are We There Yet?

Calculating Loss in Securities Fraud – Does the Modified Rescissory Method Fix the Broken Federal Sentencing Guidelines?

- » Since first enacted in 1984, the Federal Sentencing Guidelines have been amended in effect nine times with the most recent amended version of the Guidelines taking effect on November 1, 2012.
- » While certain judges have been outspoken regarding the limitations of the Guidelines and have imposed sentences that have varied significantly, others have continued to rigidly adhere to the Guidelines.
- » White collar criminal defendants are particularly incited to enter plea agreements because of the draconian penalties resulting from the overemphasis on loss as a component in sentencing.

When thinking about the sentencing guidelines for federal crimes and the various revisions since they were instituted over two decades ago, what often comes to mind is a phrase lobbed repeatedly from the backseat on many family trips... *Are we there yet?* Although the sentencing guidelines promulgated by the United States Sentencing Commission (USSC) in 1987 (“the Guidelines”) have continued to change, criticisms of the Guidelines appear to be ongoing, especially in relation to high-loss economic crimes. Unfortunately, based on the reaction to the USSC’s latest revision of the Guidelines in November 2012, the answer to that repeated question seems to be an emphatic...*NOT YET!*¹

Application of the Guidelines in federal sentencing matters has continued to be a source of confusion, frustration, and disagreement since they were implemented in 1987, especially in relation to economic

crimes such as fraud and other non-fraud white-collar crimes involving high-dollar loss amounts. Further, the latest revisions that became effective in November 2012 have not seemed to alleviate many of the prior concerns. Fewer than ten months after the current Guidelines became effective the USSC hosted a symposium on Economic Crime in September 2013 to address the “broken” Guidelines and “visions of change.”²

Background

Title 18, United States Code, § 3553(a) (1) directs sentencing courts to consider, among other things, the “nature and circumstances of the offense and the history and characteristics of the defendant.” Section 3553(a) also requires the courts “to impose a sentence sufficient but not greater than necessary to comply with the purposes” of United States sentencing: (1) retribution, (2) general deterrence, (3) specific deterrence, and (4) rehabilitation.³ However, courts are also directed by § 3553(a) to take into account the Guidelines in fashioning a sentence.⁴ While no longer mandatory, the Guidelines’ advisory range is critically important to federal judges at sentencing.⁵

The Guidelines were developed pursuant to the Sentencing Reform Act of 1984 (Title II of the Comprehensive Crime Control Act of 1984), which became effective November 1, 1987. Used in conjunction with the USSC’s sentencing tables, the Guidelines form the basis for the recommended number of months of imprisonment for those convicted of various federal crimes. Since first enacted, the

Illustration by Peter Giesbrecht



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Initially, the Guidelines were intended to be mandatory in nature (i.e., “a sentencing court must select a sentence from within the guideline range”), but certain “departures” were allowed from the guideline range if a case presented atypical features and reasons for any departure were specified by the court.⁶ In 2005 however, the Supreme Court ruled the Guidelines were merely advisory in *United States v. Booker*, 543 U.S. 220 (2005). However, district courts, “while not bound to apply

1. United States Sentencing Commission, Guidelines Manual, November 1, 2012.

2. Transcript – United States Sentencing Commission, Symposium on Economic Crime, September 18-19, 2013.

3. 18 U.S.C. § 3553(a)(2)

4. 18 U.S.C. § 3553(a)(4)

5. See *Gall v. United States*, 552 U.S. 38, 49 (2007) (“a court should begin all sentencing proceedings by correctly calculating the applicable Guidelines range”).

6. 2012 Federal Sentencing Guidelines Manual, Chapter One – Introduction Authority, and General Principles

the Guidelines, must...take them into account when sentencing.”⁷

Regardless of their “advisory nature,” the Guidelines continue to drive the sentencing in most federal criminal cases, particularly those involving economic crimes. While certain judges have been outspoken regarding the limitations of the Guidelines and have imposed sentences that have varied significantly, others have continued to rigidly adhere to the Guidelines. Regardless of a judge’s willingness to consider sentencing outside of the Guideline ranges, in reality the vast majority of cases are resolved through plea arrangements where the starting point for negotiations is, in fact, the Guidelines.

Guidelines “Loss” in Securities Fraud Cases

The Guidelines define “loss” as “the greater of actual loss or intended loss.”⁸ The sentencing judge “need only make a reasonable estimate of the loss.”⁹ Courts are to use gain as the applicable reference point “only if there is a loss but it reasonably cannot be determined.”¹⁰

In securities fraud cases, reduction in the value of securities and other corporate assets may be considered in the estimate of loss.¹¹ Prior to November 2012, the Guidelines did not expressly provide a recommended calculation method for federal judges to make a reasonable estimate of loss in securities fraud cases. As a result, courts employed various methods. These have been described as: (1) the rescissory method, considering the price a victim paid for the security with

the price after the fraud’s disclosure; (2) the modified rescissory method, considering the average price of the security during the fraud period with the average price during a set period after the fraud’s disclosure; (3) the market capitalization method, considering the change in a security’s price during a short period of time immediately before and after the fraud’s disclosure; and (4) the market-adjusted method, borrowing from civil law standards enunciated in *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005) in an attempt to calculate the change in the value of the security while excluding changes in value caused by external market forces.

Effective November 1, 2012, the Guidelines explicitly endorse the modified rescissory method for determining actual loss in securities fraud cases.¹² Specifically, they provide that:

...there shall be a rebuttable presumption that the actual loss attributable to the change in value of the security or commodity is the amount determined by –

- (I) calculating the difference between the average price of the security or commodity during the period that the fraud occurred [the “fraud period”] and the average price of the security or commodity during the 90-day period after the fraud was disclosed to the market, and*
- (II) multiplying the difference in average price by the number of shares outstanding.*

In determining whether the amount so determined is a reasonable estimate

*of the actual loss attributable to the change in value of the security or commodity, the court may consider, among other factors, the extent to which the amount so determined includes significant changes in value not resulting from the offense (e.g., changes caused by external market forces, such as changed economic circumstances, changed investor expectations, and new industry-specific or firm specific facts, conditions, or events).*¹³

Significance of Loss in Sentencing for Economic Crimes

The Guidelines focus on determination of an “offense level,” which is then used to establish a sentencing guideline pursuant to a set sentencing table.¹⁴ For example, the base level offense for fraud as defined in the sentencing Guidelines is a seven (7), which, depending on prior criminal history, equates to a minimum recommended sentence of between zero and six months.¹⁵ However, there are many other factors (i.e., “specific offense characteristics”) that can increase the offense level, and thus the recommended sentence, including factors such as: the number of victims involved, the nature of the offense, and whether the person played an “aggravating role” in the offense. However, none of the specific offense characteristics has more influence on recommended sentencing in securities and other fraud related matters than the size of the loss.¹⁶

7. 18 U.S.C. §3553(a)(4), (a)(5), *Booker*, 543 U.S. at 264

8. USSG §2B1.1, comment. (n.3(A))

9. USSG §2B1.1, comment. (n.3(C))

10. USSG §2B1.1, comment. (n.3(B))

11. USSG §2B1.1, comment. (n.3(C)(v))

12. USSG §2B1.1, comment. (n.3(F)(ix))

13. USSG §2B1.1, comment. (n.3(F)(ix))

14. USSC Sentencing Guidelines Manual; November 1, 2012

15. USSC Sentencing Guidelines Manual; November 1, 2012; §2B1.1, pg. 79-80

16. USSC Sentencing Guidelines Manual; November 1, 2012; §2B1.1, pg. 79-83

For instance, a defendant facing prosecution for a securities or other fraud-related crime where the estimated loss exceeds \$20 million could easily face up to twenty years in prison based on the recommended sentencing pursuant to the Guidelines. This is illustrated in *Figure 1*, for a defendant with a Level I Criminal History Category (lowest) facing securities fraud charges involving 250 or more victims, through a sophisticated scheme, where the defendant had an aggravating role in the offense, and the loss was found to be approximately \$20 million. This defendant would likely face a Guidelines Offense Level of 39, or up to 27 years in prison.¹⁷ (See *Figure 1*)

While a scheme involving 250 or more victims and a loss estimated at \$20 million may seem significant, in reality most alleged securities fraud violations by their nature involve a large number of potential victims (i.e., shareholders of record) and easily exceed \$20 million based on the Guidelines' current calculation methodology.¹⁹ For example, the average market capitalization of a company trading on the New York Stock Exchange (NYSE) is approximately \$8.9 billion. A 0.5% loss of market capitalization on the stock market for the average NYSE company – a level of stock price volatility many companies routinely experience – would equate to a “loss” of approximately \$44.5 million (i.e., \$8.9 billion x 0.005). Often, many securities fraud defendants face an offense level that starts in the 30s and is typically only adjusted upward from there based on the applicability of other specific offense characteristics.

What surprises many is that the above defendant – if found responsible for a 0.5%

FIGURE 1: EXAMPLE RECOMMENDED SENTENCING PER THE GUIDELINES (FOR THE DESCRIBED OFFENSE)		
	Section	Level
Base Offense Level (<i>Fraud / Non-Fraud White Collar</i>) ¹⁸	§2B1.1(a)	7
Specific Offense Characteristics		
» Loss (between \$20 and \$50 million)	§2B1.1(b)(1)	+22
» 250 or more victims	§2B1.1(b)(2)	+6
» Sophisticated means	§2B1.1(b)(10)(C)	+2
» Role in the offense	§3B1.1	+2
Level 39: 262 – 327 months (-21.8 – 27.25 years)		39

FIGURE 2: LENGTH OF IMPRISONMENT BY PRIMARY OFFENSE CATEGORY	
Primary Offense	Mean Months
Fraud (<i>Guideline Sentence Range – Offense Level 39</i>)	262-327
Murder	252
Kidnapping / Hostage Taking	197
Sexual Abuse	129
Child Pornography	132

loss of market capitalization for an average NYSE company, involving more than 250 victims, etc. – could receive a sentence equal to or in excess of average sentences for individuals found guilty of more violent crimes such as murder, kidnapping and sexual assault.²⁰ (See *Figure 2*)

With so much dependent on the weight of the estimated loss relative to other specific offense characteristics in the Guidelines, one would hope for at least a more formulaic loss determination methodology and approach. As indicated, that has proven elusive. Loss determination continues to be a source of disagreement between white-collar defense attorneys and prosecutors (and their respective financial and economic experts), as well as

the courts. As such, and with so much at stake, it is not surprising that a number of judges have been willing to impose sentences that vary from the Guidelines, sometimes significantly so, in cases where they deemed it warranted.

The problem of continued overemphasis on loss as a sentencing factor is compounded by the fact that approximately 95 percent of federal white collar criminal matters continue to be resolved before trial.²¹ In other words, white collar criminal defendants are particularly incentivized to enter plea agreements because of the draconian penalties resulting from the overemphasis on loss as component in sentencing.

17. USSC Sentencing Guidelines Manual Sentencing Table; November 1, 2012; Chapter 5 (part a), pg. 394.

18. Part B – Basic Economic Offenses of the USSC Sentencing Guidelines Manual addresses basic forms of property offenses: theft, embezzlement, fraud, forgery, counterfeiting, insider trading, transactions in stolen goods, and simple property damage or destruction.

19. Another recent Guidelines amendment notes the fallacy of enhancing a securities fraud defendant's sentence on the basis of the number of victims, where the fraud itself was based on the number of victims. See USSG §2B1.1, comment. (n.20(C)) (noting “a fraudulent statement made publicly to the market may produce an aggregate loss amount that is substantial but diffuse, with relatively small loss amounts suffered by a relatively large number of victims,” and that in such circumstances “a downward departure may be warranted.”)

20. United States Sentencing Commission, Statistical Information Packet, Fiscal Year 2012, Table 7 – Length of Imprisonment by Primary Offense Category, Fiscal Year 2012.

21. United States Sentencing Commission, Preliminary Quarterly Data Report, September 30, 2013, Table 22.

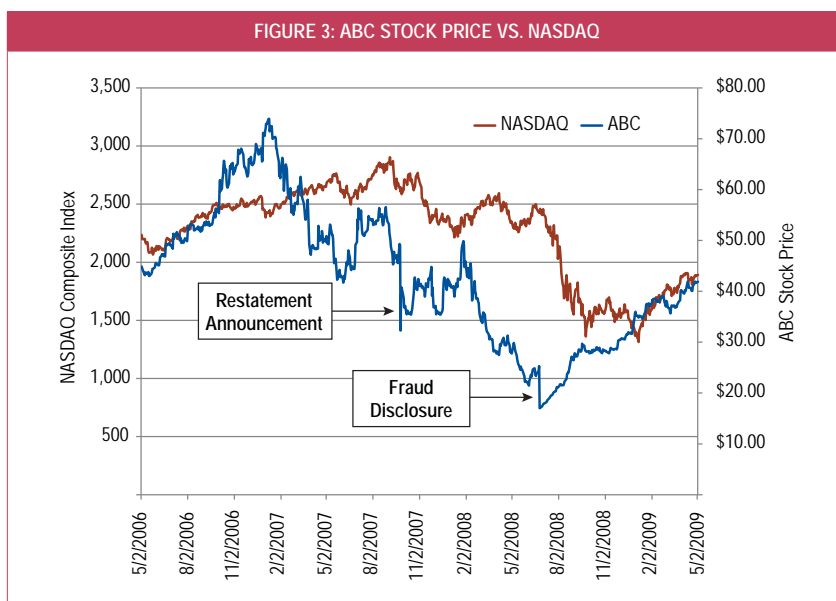
Ongoing Concerns with the Overemphasis on Loss in Federal Sentencing

Although the most recent changes to the Guidelines were intended to standardize and lessen the complexity of how loss is calculated, the changes still fall short of addressing the goals of federal sentencing. Most notably, the November 2012 changes place greater emphasis on the sentencing goal of avoiding unwarranted sentencing disparity among defendants with similar records who committed similar offenses than on reducing the impact of loss on sentence length.

As federal criminal practitioners are aware, the Guidelines' overemphasis on loss in economic crimes has been heavily criticized – with respect to loss calculation, federal judges have called the Guidelines “patently absurd on their face,” *United States v. Adelson*, 441 F.Supp.2d 506, 512 (S.D.N.Y. 2006) and “a black stain on common sense.” *United States v. Parris*, 573 F.Supp.2d 744, 754 (E.D.N.Y. 2008). However, by focusing on the disclosure of the fraud to the market as the triggering event for sentencing purposes, the modified rescissory method leads courts to consider disclosed conduct that was beyond the scope of any fraudulent activity. The modified rescissory method may even exacerbate the loss overemphasis because of its assumption that all outstanding shares incurred harm, when many investor “victims” may have purchased or sold shares during periods uninfluenced by the fraudulent activity in question.

In addition to the problems inherent in the modified rescissory method – assuming all disclosed conduct was relevant offense conduct and that all outstanding shares incurred harm – there exist challenges in its application as well.

For example, the company portrayed in *Figure 3* had a period of questionable practices that resulted in alleged fraud



and securities violations. During the ‘fraud period,’ the company, industry, and general market exhibited significant growth, profitability, and increasing prices. However, pursuant to the identification of questionable accounting / revenue recognition practices, the company determined that a restatement was required for certain years. The disclosure of the restatement led to a significant drop in the company’s stock price.

At the time however, little evidence of fraud or securities violations had been uncovered by the company or its auditors. It was not until later that the company and its auditors identified a number of accounting irregularities pursuant to the restatement efforts that raised concerns and suspicions, which ultimately led to an investigation and formal charges. The disclosure of the potential fraud along with an expanded disclosure regarding the company’s ongoing efforts to restate its financial statements led to another significant drop in the company’s stock price. Both “stock drops” occurred during periods when general market conditions and market indices were in full retreat including some sizable corrections.

In this example:

- » What constitutes ‘disclosure’ and the start of the ‘90-day period’?
- » Can there be more than one disclosure and, if so, which is more applicable?
- » Did “external market forces” or other “facts, conditions or events” impact the company’s average share price during either the fraud period or the 90-day period, and, if so, how?
- » How should a loss be apportioned (i.e., for causation) if multiple factors (fraud and non-fraud related) contributed to it (e.g., accounting errors in a restatement vs. fraud)?
- » How do you isolate the effects of the fraud from the effects of the declining market, the announced restatement, and other factors that may be influencing the prospects of the business?
- » Can the basis of an accounting restatement (i.e., the restated financials) assist in evaluating those losses that are proximately caused by a defendant’s conduct, as opposed to other misleading statements or errors that did not arise from fraud?

- » Should an individual's culpability factor into the loss calculation?

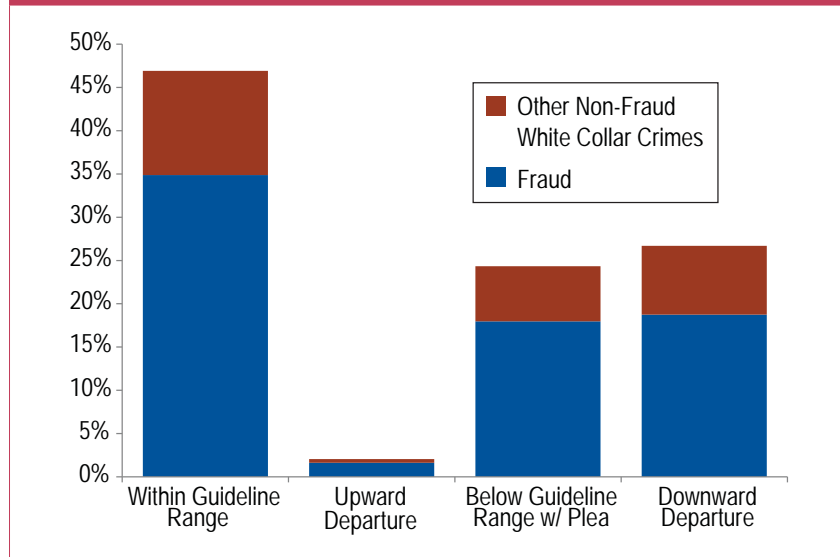
Given the circumstances described on the previous page, is it fair or reasonable to determine the loss without effectively divorcing the loss from the relative changes in a company's stock price due to other non-fraud related factors, and without due consideration of the concept of culpability? And, how do you do this without undertaking the detailed accounting, financial, and economic analysis necessary to reasonably apportion the loss between the myriad factors that contributed to it without unfairly placing all the blame on a single defendant?

Where Do We Go From Here

The Guidelines' endorsement of the modified rescissory approach in determining loss in securities fraud matters was an obvious nod to the sentencing goal of avoiding unwarranted sentencing disparity among defendants with similar records who have committed similar offenses. However, it does little to mitigate – and arguably exacerbates – the overemphasis on loss in determining sentence length. Moreover, it seems to raise as many questions as it settles – such as, in the problem posed above, what constitutes the 'fraud period,' what is the relevant 'disclosure,' and what 'facts, conditions or [other] events' are relevant to the court's determination in light of these ambiguities?

At present, it appears the current Guidelines may come no closer to providing federal judges guidance in making a reasonable estimate of loss, much less in providing a solution to the overemphasis on loss, or otherwise tailoring the Guidelines to comply with the statutory goals of federal sentencing. As a result, it is not surprising that courts across the country reflect variances from the Guideline sentencing ranges in fraud and non-fraud

FIGURE 4: SENTENCES RELATIVE TO THE GUIDELINE RANGE IN WHITE COLLAR CRIME CATEGORIES



white collar crime cases approximately 50 percent of the time.²² (See Figure 4)

Many similar arguments and ongoing concerns caused the USSC to once again invite comment and evaluation of the sentencing guidelines; and within less than a year of the most recent changes to the Guidelines (November 2012), the USSC held a symposium to address ongoing concerns of sentencing related to economic crime (United States Sentencing Commission Symposium on Economic Crime – September 18, 2013). Of particular interest was a report presented at the symposium by the American Bar Association Task Force on the Reform of Federal Sentencing For Economic Crimes, which recommended changes to the Guidelines to adjust the tables related to the impact of high-loss economic crimes on sentencing to allow for the consideration of "culpability" and "victim impact."

While the latest changes to the Guidelines were welcomed by some, it is readily apparent that shortcomings continue to exist in the Guidelines for individuals

accused of high-loss economic crimes, a factor that received focused attention at the September symposium. Unfortunately, while the participants at the symposium discussed a number of ideas that would address some of the perceived inequities, there is uncertainty as to whether any additional changes to the Guidelines will be forthcoming, or when. In reality, white-collar criminal defendants and their attorneys are left to interpret and attempt to reasonably apply the current Guidelines to their respective cases; to plead out to negotiated lesser charges; or, at times, to put their faith in judges who may, or may not, be willing to depart from the suggested sentencing. In short, the only course in addressing the modified rescissory method under the present Guidelines is to **proceed with caution!**



22. United States Sentencing Commission, Preliminary Quarterly Data Report, September 30, 2013, Table 3.