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Ninth Circuit Declines Application Of Loss Causation Principles In *Dura Pharmaceuticals* In Connection With Criminal Securities Fraud

In [*United States v. Berger*](#), No. 08-50171, 2009 WL 4141478 (9th Cir. Nov. 30, 2009), a three-judge panel of the [United States Court of Appeals for the Ninth Circuit](#) declined to apply loss causation principles in civil securities fraud litigation established by the [United States Supreme Court](#) in [*Dura Pharmaceuticals, Inc. v. Broudo*](#), 544 U.S. 336, 342-48 (2005), in connection with the sentencing of a defendant in a criminal securities fraud prosecution. Declining to follow two other circuits that had endorsed the application of *Dura Pharmaceuticals* to criminal sentencing, the Ninth Circuit held that the policies underlying the proper standard for pleading and proving a loss by investors in civil cases are not present in the criminal sentencing context and that applying *Dura Pharmaceuticals*' civil rule to criminal sentencing would clash with Congress' endorsement of that method. Notwithstanding that the split in circuit decisions may prompt Supreme Court review, this decision provides another instance where courts have applied policy distinctions between civil litigation and criminal/enforcement proceedings involving securities fraud.

The *Berger* case centers around the criminal sentencing of Richard Berger, the President and Chief Executive Officer of Craig Consumer Electronics, a publicly traded consumer electronics business ("Craig"), in connection with twelve counts of bank and securities fraud. In August 1994, Craig entered into a \$50 million revolving credit agreement with a consortium of banks. Under the agreement, the amount Craig was permitted to borrow was based on the value of its current inventory and accounts receivable. To establish Craig's eligibility to borrow, Berger and his co-defendants provided daily certification concerning Craig's assets to the banks. Between 1995 and September 1997, Craig lacked sufficient qualifying accounts to continue borrowing the funds needed for Craig's ongoing operations. As a result, Berger and his co-defendants employed various accounting schemes to falsify the information contained in the certificates. Relying on these falsifications, the banks lent millions of dollars to Craig based on either nonexistent or substantially overstated collateral.

Moreover, in connection with Craig's initial public offering, Berger publicly misrepresented the company's fiscal viability and financial condition, failing to reveal that Craig was actually operating in default of its agreement with the lending banks and was substantially overdrawn on its credit line. After an audit in 1997 revealed accounting irregularities, Craig was required to restate its earnings for 1995 and part of 1996. In the months following the restatement, Craig's stock price fell from \$4.99 to \$0.99 per share. The securities fraud and accounting irregularities were not publicly revealed until after trading in the stock was halted.

The lending banks did not learn of the fraud until Craig filed for bankruptcy in August 1997.

Berger (and others) were indicted on bank and securities fraud. Following Berger's conviction, the district court, believing controlling authority prohibited it from applying any sentencing facts not found by the jury, calculated an applicable sentencing range of zero to six months and sentenced Berger to six months imprisonment. Berger appealed his conviction and the government cross-appealed the sentence. Following recently decided Supreme Court precedent which permitted sentencing consideration of facts not found by the jury ([United States v. Booker](#), 543 U.S. 220 (2005)), the Ninth Circuit vacated Berger's sentence and remanded to the district court for re-sentencing.

On remand, the district court found several facts that significantly increased Berger's sentencing range. Among other things, the district court found that Berger's fraud caused a loss of \$3.14 million to various banks, triggering a thirteen-level enhancement in the sentencing guidelines. In addition, in determining loss to shareholders, the district court adopted the "modified market capitalization theory", *i.e.*, comparing the change in stock value of other, unaffiliated companies after accounting irregularities in those companies' records were disclosed to the market. The court determined that the average depreciation of those selected companies' stock was a certain percentage and applied that figure to the value of Craig's initial public offering (although in Craig's case, the fraud was never disclosed to the market before trading was halted). Using this theory, the court calculated that the shareholder loss triggered a fourteen-level sentencing enhancement, from level sixteen to thirty. This enhancement increased the applicable sentencing range from 21-27 months to 97-121 months. The court imposed a sentence of 97 months and Berger appealed, arguing that in calculating shareholder loss in criminal securities fraud cases, district courts must employ the civil securities fraud "loss causation" approach described in [Dura Pharmaceuticals](#), 544 U.S. 336.

In [Dura Pharmaceuticals](#), the Supreme Court ruled that to sustain a damages claim for civil securities fraud under [Section 10\(b\) of the Securities Exchange Act of 1934](#) and [Rule 10b-5](#), a *plaintiff* must show that the fraud was publicly revealed and that the disclosure caused the shareholders to suffer loss. In so holding, the Supreme Court rejected the notion that *stock overvaluation itself* resulting from so-called "fraud-on-the-market" may form the basis for a plaintiff's damages award in a private securities action. The Supreme Court has not applied its [Dura Pharmaceuticals](#) loss causation principle to sentencing enhancements in *criminal* securities fraud cases, but two federal circuit courts have suggested that they are applicable in this context. See [United States v. Olis](#), 429 F.3d 540 (5th Cir. 2005); [United States v. Rutkoske](#), 506 F.3d 170 (2d Cir. 2007). Relying on these cases, Berger argued that the district court erred by not adhering to the [Dura Pharmaceuticals](#)' civil loss causation principle in its calculation of shareholder loss.

In rejecting Berger's argument, the Court cited two reasons. First, the Court reasoned that in a civil fraud action, the plaintiff bears the burden to show loss and therefore must prove any loss was attributable directly to devaluation caused by revelation of the defendant's fraud. The Court reasoned that "it likewise

follows that a plaintiff's mere allegation that he purchased overvalued stock is insufficient to state a claim, because the allegation does not by itself establish that the plaintiff personally incurred loss commensurate with the overvaluation." The Court then distinguished *Dura Pharmaceuticals* by noting that in criminal sentencing, "a court gauges the amount of loss *caused*, i.e., the harm that society as a whole suffered from the defendant's fraud. Whether and to what extent a *particular individual* suffered actual loss is not usually an important consideration in criminal fraud sentencing". Somewhat contradictorily, the Court allowed in a footnote that the holding of *Dura Pharmaceuticals* may be "more relevant" to criminal *restitution*, but distinguished that sentencing provision as "focus[ing] on harm to the victims as opposed to loss caused by the defendant."

Second, the Ninth Circuit looked to the Sentencing Guidelines to limit the scope of *Dura Pharmaceuticals*. In arguing for the Sentencing Guidelines' interpretation, the government cited Section 2F1.1 commentary note 8 of the 1995 Guidelines which states that "the court need only make a reasonable estimate of the loss." Furthermore, Section 2F1.1 condones measuring loss by overvaluation stating that "[a] fraud may involve the misrepresentation of the value of an item that does have some value." Thus, the Court held that were *Dura Pharmaceuticals*' loss causation rule applied to criminal sentencing enhancements, "that principle's plain rejection of the overvaluation loss measurement method would collide with Congress' clear endorsement of that method." In rejecting *Dura Pharmaceuticals*' applicability, the Court also reiterated the broader rule that "[t]he Guidelines' 'relevant conduct' provision requires a defendant's sentence to be based on 'all harm that resulted from the acts or omissions' of the defendant."

In applying a broad rule to the facts of the case, the Court held that while some degree of uncertainty is tolerable, it does not obviate the requirement to show that "actual, defendant-caused loss occurred." The Court held that the district court employed a "counterfactual" approach in determining the total shareholder loss because they examined the effect on the stock value of *other, unrelated companies* after accounting irregularities were disclosed to the market. Furthermore, the measure of loss was not based on Craig's finances or on the actual effect of Berger's fraud. As a result, the Court held that "the method did not properly establish that Berger's sentence was based only on 'all harm that resulted from the acts or omissions' of the *defendant*," and, as such, was an abuse of discretion. The Court therefore remanded the case to the district court to redetermine how much of the shareholders' loss was actually caused by Berger's fraud.

The *Berger* decision demonstrates the Ninth Circuit's refusal to endorse the civil loss causation principle in finding shareholder loss to criminal securities fraud sentencing. It also reflects a divergence from the Second and Fifth Circuits, creating a circuit-split ripe for review by the United States Supreme Court.

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