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The Increasing Importance Of Loss Causation Analysis

Law360, New York (October 11, 2011, 1:56 PM ET) -- The recent court decisions in *United States v. Anthony Cuti et al.* and *United States v. Ferguson et al.* highlight the increasing importance of correctly analyzing loss causation in criminal cases. In *United States v. Cuti*, a New York federal judge applied considerably shorter prison sentences than were recommended by prosecutors for two former executives of Duane Reade Inc. convicted of securities fraud.[1]

In *United States v. Ferguson*, the U.S. Court of Appeals for the Second Circuit overturned criminal convictions of four former General Re Corporation (Gen Re) executives and a former American International Group Inc. (AIG) executive.[2] Both court decisions were driven by conclusions that prosecutors failed to properly connect the alleged fraud to any actual losses.

The Role of Loss Causation in Criminal Securities Cases

In criminal securities fraud cases, the amount of loss resulting from the fraud is often the most important factor in sentencing decisions. The current Federal U.S. Sentencing Guidelines stipulate that sentencing courts "need only make a reasonable estimate of loss ... based on available information," and although the court need not establish the loss with precision, it may not engage in "pure speculation." [3]

The guidelines, however, do not set forth standards on how to determine a reasonable estimate of loss, leaving each court to develop its own standards. The government bears the burden to prove both the existence and the amount of the loss attributable to the offenses of conviction. [4]

A simplified measure of loss often proffered by the government is the decline in a company's stock price following the revelation of fraud. It is well established in the civil securities case law that this simple measure may not be an appropriate measure of loss because it assumes that the entire decline in price was caused by the revelation of fraud. For example, if the stock price declined because of changes in market or industry conditions, then this measure of loss may grossly overestimate the effect of the alleged fraud, unfairly adding years to sentences.

Whether an investor incurred losses caused by the fraud depends on many factors, such as the economic environment, new developments in the industry, or firm-specific conditions unrelated to the alleged fraud. Properly addressing loss causation requires careful analyses to establish the extent to which the company's stock price was affected by the fraudulent information, as opposed to other unrelated factors. [5]

United States v. Cuti

In *United States v. Cuti*, two former executives of drug-store chain Duane Reade were convicted of improperly inflating the company's earnings by means of a scheme involving

transactions with real estate lease contracts. According to the prosecution, Duane Reade would sell worthless store lease contracts to a third party. To induce the third party to purchase worthless contracts, Duane Reade would compensate it in the form of commissions for other services. Duane Reade would account for these transactions by booking immediate income from the sale of the lease but amortizing the commission expenses over several years. Thus, while these round-trip transactions would have no real effect on the company's finances, its reported earnings would increase at the time of the fraudulent transaction.

Following the jury verdict, the court held a Fatico hearing to determine whether any loss occurred as a result of the scheme. Prosecutors identified a private equity firm, which acquired all of Duane Reade's outstanding stock before any disclosure of offenses, as the sole victim of the fraud. According to the prosecution, the private equity firm was misled by Duane Reade's inflated historical earnings and thereby overpaid for the company by \$20 to \$50 million.

Since the fraud was discovered after Duane Reade was acquired and taken private, there was no way to observe whether the disclosure of the fraud affected Duane Reade's stock price. Instead, the government argued that the private equity firm paid too much for Duane Reade's stock when it acquired the company and was harmed because the company was actually worth less than the firm had previously thought. Indeed, the crux of the government's argument was that since reported historical earnings were higher than actual earnings, the private equity firm must have overpaid. The government offered expert testimony about how much the private equity firm overpaid based on various valuation multiples applied to Duane Reade's historical earnings that were allegedly inflated.

The defendants countered that the offense for which they were convicted did not cause any actual loss to the private equity firm because it had all of the relevant information required to conduct a proper valuation of Duane Reade, which was unaffected by the alleged fraud. First, over the 12 months prior to the final acquisition negotiations, no fraudulent transactions occurred. Thus, the prosecution was unable to show how the fraud affected the most recent financial results available when the final acquisition price was determined.

Second, the private equity firm did not rely on allegedly inflated historical real estate income to make projections for this income going forward. Instead, the private equity firm hired several independent consultants to estimate the value of the existing leases that Duane Reade owned at the time of the acquisition. The value of these leases, the best estimate of the potential for real estate income going forward, was based on the difference between current rental rates and the rates specified in the lease contracts and was completely unaffected by the fraud.

Duane Reade subsequently recorded the value of these leases as an asset on its books, and it never restated that value. Finally, the defense showed evidence that questioned whether the private equity firm would have actually been able to acquire Duane Reade had it insisted on a lower price, meaning it may have missed out on the handsome profit that it actually earned when it subsequently sold Duane Reade to Walgreens.

Based on the testimony of the defense, the court concluded that the government failed to prove any loss. The government's initial loss estimate of \$20 to \$50 million implied a 22-level increase in the total offense level for both defendants. On that basis and other grounds, the government recommended prison sentences between 17.5 and 22 years for one of the executives, who was convicted of conspiracy, securities fraud and making false statements to the U.S. Securities and Exchange Commission, and about five years for the other executive, who was convicted only of securities fraud.

However, the government's failure to establish any loss attributable to the offenses of convictions led the court to disregard the suggested sentencing enhancement and sentence

the defendants to considerably shorter terms of three years for the first executive and a supervised release for the other executive.

This decision shows that challenging the calculation of securities fraud losses and raising the possibility of other factors influencing investors' losses may support the position that the government failed to establish loss with reasonable certainty. Given the critical role that the amount of loss attributable to the fraud plays in sentencing decisions, it is particularly important to identify a proper loss calculation methodology that is feasible under the circumstances and suitable to be used for determining fair sentencing.

United States v. Ferguson

Although establishing loss causation is typically more important in sentencing than in a finding of guilt in criminal cases, a recent ruling by the U.S. Court of Appeals for the Second Circuit in *United States v. Ferguson* shows that prosecutors have to properly establish the effect of the fraud on stock prices if they use a decline in stock prices as evidence of the fraud.

On Aug. 1, 2011, the Second Circuit overturned criminal convictions of four former Gen Re executives and a former AIG executive on the basis that the jury was given a false impression of the losses caused by the alleged fraud. The defendants were convicted of administering an allegedly fraudulent reinsurance transaction between AIG and Gen Re that was intended to hide AIG's declining loss reserves, which were believed to negatively affect the company's stock price.

The government based its case on testimony from two cooperating witnesses and contemporaneous recordings of calls involving the defendants and witnesses. The government also introduced stock price charts to show the material effect of the alleged fraud on investors: AIG's stock price declined steeply as details about the regulatory investigation of the allegedly fraudulent transaction were disclosed. Following convictions, the defendants were sentenced to prison terms ranging from one to four years.

The defendants appealed on a variety of grounds. One of the reasons for appeal was that the AIG stock price charts that the government presented to the jury were prejudicial. The alleged fraud was one of many problems besetting AIG at that time, including unrelated allegations of bid rigging, improper self-dealing and earnings manipulation. These unrelated problems could account for some or all of the company's stock price decline during the relevant period. However, none were mentioned to the jury when the government presented the stock price charts. Because of this omission, the jury members were left to believe that the entire decline in AIG's stock price during the relevant period was attributable to the alleged fraud.

On appeal, the Second Circuit held that the district court abused its discretion in admitting the AIG stock price charts because those charts were exploited by the government to emphasize the losses caused by the transaction when there was no foundation to do so. For these and other reasons, the defendants' convictions were vacated, and the case was remanded to the district court for retrial.

In its decision, the Second Circuit noted that the charged offenses did not require a showing of "a causal connection between the material misrepresentation and the loss," stating that "if no offer to stipulate were forthcoming, the government could have relied upon the sufficiency of its other materiality evidence." [6] The court also noted that, alternatively, the government could have used expert testimony to estimate the effect of the alleged fraud on the stock price.

The decision is important in setting a standard for the use and implementation of loss causation analysis in criminal conviction decisions. If a loss theory is to be used to argue

guilt, prosecutors must show the amount of loss caused by the fraud, which should exclude losses attributable to factors other than the alleged misconduct. A proper loss causation analysis is also critical for presenting the appropriate evidence to the jury regarding the materiality of the effect of the alleged fraud.

Conclusions

As two recent criminal cases illustrate, properly establishing loss causation is important for both convicting and sentencing decisions. Properly addressing loss causation in a criminal securities case requires careful and sophisticated analyses to establish whether and to what extent the alleged fraud caused investor losses.

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Cornerstone Research was retained by Hoguet Newman Regal & Kenney, counsel for William Tennant in United States v. Anthony Cuti and William Tennant.

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[1] Case number 1:08-cr-00972, in the U.S. District Court for the Southern District of New York.

[2] Case number 08-6211-cr, in the U.S. Court of Appeals for the Second Circuit.

[3] U.S.S.G. §2B1.1 (App. Note 3(C)); United States v. Uddin, 551 F.3d 176, 180 (2d Cir. 2009) quoting United States v. Carboni, 204 F.3d 39, 46 (2d Cir. 2000); United States v. Deutsch, 987 F.2d 878, 886 (2d Cir. 1993).

[4] United States v. Williams, 247 F.3d 353, 358 n. 7 (2d Cir. 2001).

[5] Dura Pharmaceuticals Inc. v. Broudo, 544 U.S. 336 (2005).

[6] United States v. Ferguson, No. 08-6211-cr (2d Cir. 2011)

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