

REFORMING PUNISHMENT OF FINANCIAL REPORTING FRAUD

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INTRODUCTION

Two obvious questions dominate the many cases of malfeasance in corporations and markets that have arrived in the criminal justice system during the last five years: Was the behavior at issue criminal? If so, for how long (if it all) should the perpetrators be sent to prison? Thorough pursuit of either question involves challenging theoretical inquiries. On the second question (punishment), however, the law suffers at a facial level from an embarrassment. Extant criminal law has not come close to working out even the easiest parts of the question of how to punish financial reporting fraud. The United States legal system is botching things even as the courts routinely face decisions with grave consequences: Should the former chief executive officer of a Fortune 500 company, whose shareholders lost hundreds of millions when the company revealed falsity in its finances, be sent to prison for months, years, a decade or even life without parole?¹

My goal is to describe some concrete steps to rationalize the process of sentencing corporate offenders in the cases of large-scale financial reporting fraud that have been prevalent since 2001. Even if we set aside some heavy normative questions, such as the wisdom of imprisonment as a sanction for white-collar offenders, the proper mix of deterrent and retributive aims in such cases, and the appropriate theoretical methodology for deriving the “optimal” or “just” sentence in a given case, at least three accessible problems remain. First, we need a scale for comparing one case to another. Second, we need a

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¹ See, e.g., *United States v. Adelson*, 441 F. Supp. 2d 506 (S.D.N.Y. 2006) (sentence of forty-two months’ imprisonment for forty-year-old first-time offender in case in which federal guidelines appeared to call for sentence of eighty-five years’ imprisonment).

methodology for fixing the location of a given case on that scale. Third, even if we are unsure exactly how to calibrate the scale, its contours (where it begins and ends and the rate at which it increases) must satisfy minimum requirements of rationality. Current law suffers from serious deficits in at least two of these three areas and leaves ample room for what ought to be uncontroversial improvement.

Many of the law's failings in this area are due to lack of understanding and foresight of the special (but now ubiquitous) fraud case involving accounting falsehood perpetrated on a large, liquid market for investment in a public company. In recent years, sentencing guidelines projects, in spite of their many flaws, have made significant strides in working out methods to measure and compare many common criminal cases, from narcotics to weapons to theft offenses. However, guidelines methods developed to date—particularly those commonly used for economic offenses—do not easily translate to the offense of financial reporting fraud in large public companies whose securities are traded on liquid markets. This crime, it turns out, is qualitatively different (not just larger) than ordinary fraud. The motives, the identity of the victim, the manner in which the victim is harmed and the gain to the offender all look different. Failing to account for these differences can result in errors of measurement that produce inequity and irrationality in sentencing.

These deficiencies in sentencing law are unavoidable in confronting the problem that motivates this Symposium. In a federal system of policing and punishing financial fraud, concerns include that uncoordinated actions of multiple sanctioning authorities could lead to over-sanctioning of fraud, resulting in over-deterrence and unjust punishment. Additionally, lack of coordination could lead to discord and confusion in the expressive effects of punishing white-collar crime. These concerns cannot be addressed in the absence of rough consensus across jurisdictions, around a focal point in law, about scale and methodology for measuring and aligning a given group of cases eligible for punishment.

My inquiry requires some working assumptions, which are contestable of course, but sufficiently track prevailing political and legal consensus as to be necessary to any practical effort to achieve reform of sentencing law. I assume that some major cases of financial fraud are punished criminally, in service of a mix of deterrent and retributive aims.² I assume that punishments in serious fraud cases that do not include some imprisonment trivialize the conduct, undermining deterrent and expressive effects of criminalizing fraud and offending

² I have written elsewhere about how we determine which cases to treat criminally. See Samuel W. Buell, *Novel Criminal Fraud*, 81 N.Y.U. L. REV. 1971 (2006).

values related to equal treatment of individuals in the criminal process without regard to socio-economic status. I assume that proportionality is a requirement across all major white-collar cases; like cases should be treated alike, different cases should be treated differently and criminal sentences should not vary substantially according to nonrelevant factors (such as the location of prosecution, identity of sentencing judge, or heat of public emotion). Finally, I assume that the federal government continues to investigate, prosecute and punish many major fraud cases. Thus, federal law provides a focal point for both public consciousness about white collar crime and policy deliberations of other jurisdictions.

In addition to working from these assumptions, I will bracket plea bargaining. Indisputably, plea bargaining has a greater impact on disparities in sentencing than do lack of principle or clarity in sentencing law or variations among the practices of sentencing judges. Plea bargaining exerts enormous influence over punishment in individual cases (to take one common example, by capping a defendant's sentence through a plea to a single count with a small statutory maximum). It also controls the disposition of nearly all criminal cases. The influence of plea bargaining on sentences for financial reporting fraud, however, is no reason to ignore deficits in the positive law that otherwise controls punishment (and in the shadow of which prosecutors and defendants may bargain).³ While the subject of plea bargaining is at least of equal importance, it is beyond the scope of this Symposium contribution.

My inquiry will describe federal sentencing law and how it should be improved as to each of the three requirements that concern me (i.e., a scale, a methodology for placing cases on the scale and calibration of the scale). In Part I, I will supply a hypothetical case that will assist my analysis. In Part II, I will describe the best available scale for measuring cases of financial fraud; here, present law is closest to what I recommend. In Part III, I will describe the best available methodology for fixing cases on the scale; present law here is deficient and fractured. In Part IV, I will consider how to calibrate the scale; here, present law urgently needs major revision. In Part V, I will briefly discuss procedural avenues for changing sentencing law in the desirable direction.

Let me preview my conclusions. Monetary loss to victims is the best available scale for comparing cases of financial reporting fraud and the United States Sentencing Guidelines are the best available coordination device for applying that scale across cases.⁴ The best of

³ *But see* William J. Stuntz, *Plea Bargaining and Criminal Law's Disappearing Shadow*, 117 HARV. L. REV. 2548 (2004).

⁴ The Guidelines used to be binding but are now advisory. *See* *United States v. Booker*, 543 U.S. 220, 245 (2005). Nonetheless, they remain a focal point for sentencing and judges are still

many methodologies for measuring loss to victims (some so complex as to be unworkable) compares a company's average share price during the fraud with its average share price in the ninety days following the fraud's revelation. It further excludes periods during which significant events unrelated to the fraud moved the share price and adjusts for the stock's historical relationship to movements in the market. The existing scale in the Guidelines must be both compressed (it escalates too fast) and shifted downward (the high end of the scale which can result in sentences of life imprisonment without parole would be laughable if it were not operational law of punishment). Some Guidelines provisions that double-count for relevant factors must be eliminated. Finally, in a hierarchy of means for reform, congressional correction of the Guidelines would be best but is least likely; Sentencing Commission revision of the Guidelines is easily achievable and would be authorized; and judicial modification of the rules is least desirable but authorized and necessary in the absence of (or pending) congressional or Sentencing Commission action.

I. HYPOTHETICAL

Consider an admittedly oversimplified hypothetical that exemplifies the sentencing problem presented by recent cases of reporting fraud in public corporations. Suppose that Acme Corporation's stock is traded on the NYSE and is among the S&P 500. Acme has been a public company for more than ten years. Through numerous divisions and subsidiaries, it manufactures and sells telecommunications products. CEO was the Chief Executive Officer of Acme. COO was the Chief Operating Officer. CFO was the Chief Financial Officer. CAO was the Chief Accounting Officer. CON was the Controller.

The following events occurred at Acme between 2002 and the middle of 2006:

- *2002 through 2004*: Acme greatly expanded its operations, acquiring businesses and assets, adding new divisions, issuing new equity, increasing debt and employing a variety of complex financing arrangements. Acme's stock steadily rose in value, suffering no major decline between 2002 and the end of 2004. On January 1, 2002, Acme's stock traded at thirty dollars per share with ten million

required to conduct a Guidelines calculation in any sentencing analysis. *See, e.g.*, United States v. Reinhart, 442 F.3d 857, 864 (5th Cir. 2006).

shares outstanding. On January 1, 2005, the stock traded at fifty dollars per share, with twenty million shares outstanding.

- *January 2, 2005:* COO, CFO and CAO met to discuss company operations. Wall Street analysts were predicting a great first quarter 2005 for Acme, with steadily increasing earnings growth. COO reported that he had just learned from company engineers that a system Acme had been touting for two years as a prime growth business—a means of live video broadcasting to cell phones—would require an additional cash expenditure of \$500 million to be operational on schedule.

There was more bad news. CFO reported that a bank acting as the outside investor in PSHIP LLP, a partnership created by Acme to raise funds through borrowing while keeping debt off Acme's balance sheet, informed him that it would invoke a contractual provision that, according to the bank, allowed the bank to redeem its equity in PSHIP LLP and withdraw from the partnership. Acme, CFO said, would be forced to consolidate PSHIP LLP on its own balance sheet if it could not locate a substitute investor, which seemed unlikely. PSHIP LLP was carrying \$500 million in debt. COO and CFO said CEO would fire all three of them if Acme's stock declined upon announcement of its first quarter results.

CAO suggested a plan to avoid this. CAO explained that they could tell the bank that Acme would immediately repurchase the bank's equity stake in PSHIP LLP, as long as the bank allowed Acme to keep the bank as an equity partner "on paper." Then, CAO explained, they could borrow an additional \$500 million through PSHIP LLP to maintain funding for Acme's cell phone venture. CAO said, "I'll handle the auditors." The three agreed to implement CAO's plan and then did so. CAO lied to Acme's outside auditor about the bank's continued equity position in PSHIP LLP and the auditors did not seek verification from the bank.

- *April 1, 2005:* Acme reported strong first quarter earnings, consistent with Wall Street expectations.

- *April 1 to June 1, 2005*: Acme's stock continued to rise through the second quarter, reaching sixty dollars per share on June 1, 2005.
- *June 15, 2005*: CON discovered documents revealing CAO's scheme. CON forwarded the documents to CEO. An alarmed CEO consulted Acme's outside counsel at the law firm of Attorney & Lawyer.
- *June 30, 2005*: After a brief investigation, Attorney & Lawyer recommended that CEO immediately disclose the accounting violations and record any necessary charges and corrections to Acme's reported earnings and balance sheet.
- *July 1, 2005*: CEO conducted a conference call with investors and analysts to discuss Acme's second quarter results. During the call, CEO publicly reported that PSHIP LLP had been improperly deconsolidated in Acme's first quarter's results; that Acme would file a restatement of first quarter results with the SEC; that the company would increase recorded debt by one billion dollars; and that Acme could no longer predict when its new cell phone venture would be operational. Standard & Poor's immediately downgraded Acme's credit rating from A+ to B+.
- *July 1 to July 6, 2005*: Acme's stock declined sharply, from sixty to twenty dollars.
- *July 6 to December 31, 2005*: Acme's stock further declined steadily, from twenty to ten dollars. (Assume that the S&P 500 was flat during this time.)
- *January 1 to July 1, 2006*: Acme's stock rallied to twenty dollars per share. (Again, assume the S&P 500 remained flat.)

Suppose that COO, CFO and CAO stand before the district court for sentencing. Each was convicted of many counts of securities fraud, meaning that the maximum statutory exposure is decades of imprisonment.⁵ The salient features of the Acme hypothetical are summarized below:

⁵ See, e.g., 18 U.S.C. § 1348 (2006) (twenty-five-year maximum per count).

DATE	EVENT	SHARE PRICE	SHARES
January 1, 2002	None	\$30	10,000,000
January 1, 2005	Three years of successful operations	\$50	20,000,000
January 2, 2005	COO, CFO and CAO learn of problems and plan accounting fraud	\$50	20,000,000
April 1, 2005	Increased first quarter earnings announced	\$55	20,000,000
June 15, 2005	CEO learns of accounting fraud and investigates	\$58	20,000,000
July 1, 2005	Accounting fraud disclosed; debt increased one billion dollars; cell phone venture on hold; rating agencies downgrade	\$60	20,000,000
July 6, 2005	Decline in share price slows	\$20	20,000,000
December 31, 2005	Decline in share price concludes	\$10	20,000,000
July 1, 2006	Most recent available price	\$30	20,000,000

II. A SCALE FOR MEASURING CASES

The major premise of the sentencing reform movement of the last thirty years holds that proportionality and equality require systematic efforts to treat like cases alike and different cases differently.⁶ The empirical conclusion that gave birth to the Guidelines was that relying

⁶ See Susan R. Klein & Jordan M. Steiker, *The Search for Equality in Criminal Sentencing*, 2002 SUP. CT. REV. 223, 229-34.

on the efforts of individual judges to achieve proportionality and equality was hopeless.⁷ Left untethered by law (other than usually immaterial statutory maxima), sentencing judges created, through accumulated individual punishment decisions, a system amounting to a lottery. The length of a defendant's sentence depended as much on where (Boston or Birmingham?) and before whom (Johnson or Reagan appointee?) a defendant stood than on relevant factors such as the degree of planning or harm involved in the offense.⁸ White-collar sentences especially displayed this pathology before the advent of the United States Sentencing Guidelines.⁹

Whatever one thinks about the success or failure of the Guidelines in addressing this concern, it is hard to argue with the project's mission, at least in original form. We ought to punish criminal behavior according to what motivates us to criminalize that behavior. The choice to have a program of sending people to prison for offenses against society is, after all, a policy choice taken by society as a whole. Society has a powerful interest in seeing that the project is carried out in keeping with its purposes. Nothing in the motivating purposes of the project of criminal prohibition involves a desire for chance and inconsistency.¹⁰

The rub (some say fatal) in the Guidelines enterprise is how to measure crimes with a method that can be used across a series of cases, such that one case can be compared to another.¹¹ The Guidelines have been an experiment in whether there is a workable middle in measuring the seriousness of criminal cases between, for example, saying, "All robberies deserve ten years in prison" and saying, "A robbery deserves whatever sentence between zero and twenty years in prison the given judge in a given case thinks it deserves."¹²

For the crime of fraud, the Guidelines have settled on monetary loss to victims as the relevant middle position. Here, I will embrace existing law, arguing that victim loss is generally the correct guiding principle for measuring the seriousness of financial reporting fraud. It is important to understand what leads to this conclusion and to evaluate some alternatives.

Start with the current federal Guidelines. In the most recent

⁷ See *id.*

⁸ See *id.*

⁹ Compare, e.g., *United States v. Bergman*, 416 F. Supp. 496 (S.D.N.Y. 1976) (sentence of four months' imprisonment for multi-million-dollar nursing home fraud), with *Browder v. United States*, 398 F. Supp. 1042 (D. Or. 1975) (sentence of twenty-five years' imprisonment for pledging \$500,000 of stolen securities).

¹⁰ See Klein & Steiker, *supra* note 6, at 224-25.

¹¹ See, e.g., Albert W. Alschuler, *The Failure of Sentencing Guidelines: A Plea for Less Aggregation*, 58 U. CHI. L. REV. 901, 918-24 (1991).

¹² See *Blakely v. Washington*, 542 U.S. 296, 328-40 (2004) (Breyer, J., dissenting).

version, they begin with a “base offense level” of seven in any case of securities fraud.¹³ The Guidelines then add from zero to thirty levels, depending on the amount of loss.¹⁴ The loss table, which applies to every case of fraud and theft, as well as nearly all other economic crimes, rises this way:

LOSS	LEVEL INCREASE
≤ \$5,000	0
> \$5,000	2
> \$10,000	4
> \$30,000	6
> \$70,000	8
> \$120,000	10
> \$200,000	12
> \$400,000	14
> \$1,000,000	16
> \$2,500,000	18
> \$7,000,000	20
> \$20,000,000	22
> \$50,000,000	24
> \$100,000,000	26
> \$200,000,000	28
> \$400,000,000	30

As I will discuss in Part IV, factors in addition to dollar loss can greatly affect a Guidelines sentence in a major fraud case. But dollar loss is the dominant factor. The loss table can add anything from zero to thirty points to a defendant’s total offense level. The sentencing table (the Guidelines’ bottom-line chart for calculating sentences) tops off at level 43 (which calls for life without parole).¹⁵ Controlling for other factors, the difference in prison time between the addition of zero or thirty points (the full range of the loss table) can be as much as thirty years’ incarceration.

The Guidelines’ sentencing table is an accelerating scale. At the low end, two levels add about six months to a prison sentence; ten levels add about three years. At the high end of the Guidelines scale, two levels add about five years to a prison sentence; the addition of ten levels can add sixteen years or more, or even push a sentence to life without parole. In our Acme example, however one ends up measuring loss (more on that in Part III), COO, CFO and CAO face long increases in their prison sentences because their accounting fraud resulted in large

¹³ U.S. SENTENCING GUIDELINES MANUAL § 2B1.1(a)(1) (2005).

¹⁴ *Id.* § 2B1.1(b)(1).

¹⁵ *Id.* app. § 5A. Sentencing Table.

monetary loss to investors.

The Sentencing Commission explains that “loss is the greater of actual loss or intended loss.”¹⁶ “Actual loss” is defined as “the reasonably *foreseeable* pecuniary harm that resulted from the offense.”¹⁷ Pecuniary harm is “reasonably foreseeable” if the defendant “knew or, under the circumstances, reasonably should have known, [that it] was a potential result of the offense.”¹⁸ “Intended loss” is intended “pecuniary harm,” even if such harm was unlikely to occur.¹⁹

In a case of accounting fraud in a public company like our Acme example, actual loss is likely to control at sentencing since it is often too difficult to identify the loss to victims that was “intended” by a corporate executive who manipulated financial results in order to obtain prestige, job security, compensation, personal portfolio gains and so on.²⁰ Put differently, even if we held a strong preference for measuring offense seriousness by intended loss (because we believed that blameworthiness corresponds to culpable of mental state, not fortuity of harm caused), we would be hard-pressed to adhere to that position in a case of accounting fraud in a public market. Furthermore, the Sentencing Commission has decided that *gain* resulting from the offense is only to be used if the loss “reasonably cannot be determined.”²¹

That any systematic effort to compare one financial crime to another would settle on a monetary measure is almost too obvious to need exploration.²² We care about fraud because it involves the wrongful deprivation of a person’s economic interests. To measure its gravity, we would have to start with the question how much economic deprivation the perpetrator sought or achieved. Cheating someone out of a dollar is not cheating someone out of her life savings. As important, a monetary measure has universality and liquidity, allowing comparison of large numbers of cases across many jurisdictions involving an infinite variety of transactions.

How much one likes *loss* as the relevant monetary measure depends somewhat on how one comes out on the mix of deterrent and retributive objectives for punishing white collar crime. For a purely

¹⁶ *Id.* § 2B1.1 cmt. n.3(A).

¹⁷ *Id.* § 2B1.1 cmt. n.3(A)(i) (emphasis added).

¹⁸ *Id.* § 2B1.1 cmt. n.3(A)(iv).

¹⁹ *Id.* § 2B1.1 cmt. n.3(A)(ii).

²⁰ It is also difficult to determine what the “reasonably foreseeable” results of revelation of accounting manipulation might be on a company’s stock price given the unpredictability of markets. See, e.g., Donald C. Langevoort, *Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation*, 97 NW. U. L. REV. 135 (2002).

²¹ U.S. SENTENCING GUIDELINES MANUAL § 2B1.1 cmt. n.3(B).

²² For exhaustive argument in support of this proposition, see Frank O. Bowman, III, *Coping With “Loss”: A Re-Examination of Sentencing Federal Economic Crimes Under the Guidelines*, 51 VAND. L. REV. 461, 465, 475-83, 497 (1998).

deterrent program, one might prefer using actual or intended *gain* as the monetary measure, on the theory that more punishment will be needed to discourage the putative offender who believes he has more to gain.²³ The Guidelines' choice of loss, however, matches longstanding practice in Anglo-American criminal law of measuring the severity of property crimes by the value of property involved.²⁴ Exclusive concern with actual or intended gain—even if it were possible to quantify such a figure in an accounting fraud case—would not correspond sufficiently to the persistent retributive motivation behind society's criminal response to property offenses.²⁵

More problematic, in cases of accounting fraud in publicly traded companies, analysis of gain to the offender and loss to the victim does not correspond to the kind of gain/loss analysis we might envision in a cookie-cutter case of fraud (such as when a perpetrator cheats an individual by persuading her to purchase a phony investment device). In financial reporting fraud, the relationship between the victim's loss and the offender's gain is complicated and indirect. Consider our Acme example. COO, CFO and CAO constructed an accounting fraud in order to avoid losing their jobs, a motivation probably connected to some mixture of benefits including salary, the performance of stock options, stability and security for their families and prestige and future career prospects. Victims who purchased over-valued Acme stock and held the stock while it declined following revelation of the fraud lost a portion of their individual wealth (perhaps leading in some cases to ruin), but in a liquid public market at most only some, and possibly none, of those losses ended up in the hands of the perpetrators. Employees and others also may have suffered economic damage from the effects of the fraud and its revelation on Acme; but none of their losses flowed to COO, CFO and CAO.

Given these complications, we need to consider more particularly what motivates the punishment of *this* form of fraud. COO, CFO and CAO committed an offense that visited economic harm on many people, but not in the sense that they *took* those people's money. Rather, as public company officers, they criminally breached a duty to manage the wealth of others responsibly and for the benefit of those others, not themselves. Their purposeful breach of that responsibility not only harmed those who entrusted their wealth to these officers; it also damaged the confidence of others not invested in this particular enterprise about investing their funds in public equity markets.²⁶ Their

²³ See Steven Shavell, *Criminal Law and the Optimal Use of Nonmonetary Sanctions as a Deterrent*, 85 COLUM. L. REV. 1232, 1237, 1248 (1985).

²⁴ See Bowman, III, *supra* note 22, at 479.

²⁵ See *id.* at 498-99.

²⁶ See John C. Coffee, Jr., *Are We Really Getting Tough on White Collar Crime?*, 15 FED.

offense could impede the flow of capital.²⁷

If punishing financial reporting fraud is a response to an intentional breach of trust by a public company officer, then the seriousness of the crime is properly measured by the amount of trust that the officer held and violated. The more investor funds lost or placed at risk, the worse the fraud. At least in cases of financial reporting fraud, stakeholder loss is preferable to perpetrator gain among possible monetary measures of offense seriousness. Note one choice we must make here. The bigger the company (in terms of market capitalization), the more punishment follows. We could measure loss on a size-relative rather than absolute basis. But that would require us to depart from our focus on harm to, and trust among, investors for some reason other than just leniency—which is addressed by how we set our scale, as discussed in Part IV.

We should consider one other option for a monetary measure. We could measure the seriousness of the accounting fraud by the quantity of impact on the public company's financial results.²⁸ In our Acme example, we could disregard the information about share price, number of shares, and so on, and focus solely on the changes in Acme's reported numbers. PSHIP LLP should have been consolidated on Acme's financial results for the first quarter of 2005. The failure to consolidate PSHIP LLP caused Acme to underreport its debt by one billion dollars. On this account, COO, CFO and CAO's offense has the seriousness of a one billion dollar accounting fraud relative to other accounting frauds. If the fraud persisted over multiple reporting periods, we might multiply the quantity of the misstated accounting numbers by the number of periods. We would have to add one other step to this method: Calculate the amount of the reporting correction relative to the size of Acme (e.g., the fraud amounted to twenty percent of the company's overall debt load).²⁹

Some obvious troubles disqualify this approach. Most problematic, in some cases it could remove the principle of materiality from the punishment analysis.³⁰ Materiality, after all, is not just a

SENT'G REP. 245, 247 (2003) (arguing that "securities fraud has macro-economic consequences" because "the victims are not just the shareholders of [the subject company] but shareholders in all other public corporations whose share prices have also been discounted because investors no longer trust the credibility of reported financial results").

²⁷ See *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 345 (2005) ("The securities statutes seek to maintain public confidence in the marketplace.").

²⁸ See *Coffee*, *supra* note 26, at 247.

²⁹ See also *United States v. Grabske*, 260 F. Supp. 2d 866, 875 (N.D. Cal. 2002) (suggesting that a method such as this one would connect a defendant's punishment "to his conduct and his intent rather than the fortuity of what happens to the price of the stock before or after the fraud is disclosed").

³⁰ See *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) (stating that omitted information is material if there is a "substantial likelihood that the disclosure . . . would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information

minimum requirement for fraud liability. It is also a relative concept about seriousness of fraud. The more that inaccurate financial data matters to investors in their decision whether to buy, sell, or hold a security, the more damage that data can cause. To know how much damage could or did result from Acme's hiding of one billion dollars in debt, we need to know how much that data mattered to Acme's investors, not just how large the number was relative to the financial misstatements of other public companies. In determining the seriousness of the fraud, it makes little sense to disregard the best measure of that data's impact, that is, the market.

In addition, a monetary measurement that looks at the company's financial statements easily can miss important and harmful components of securities fraud in a public company. In our example, Acme would have failed to meet its target date for its new cell phone venture, which was an important contributor to its share price, without placing additional debt funding in the improperly deconsolidated partnership, PSHIP LLP. The accounting fraud enabled Acme's executives to continue to tell shareholders that the cell phone venture was on track when, in the absence of the fraud, the executives would have had to concede that the promising new venture was in trouble. Raw quantification of the accounting correction does not capture this component of the fraud.³¹ Therefore, loss measurable in terms of share price is preferable to numbers associated with accounting adjustments as a measure of offense seriousness.

A final aspect of the problem of a scale for measuring cases has dominated public discussion about sentencing in recent years. Should application of whatever scale we choose be mandatory in fashioning any criminal sentence? As a matter of constitutional law, the Supreme Court has now said a sentencing guideline such as a loss scale cannot be mandatory unless a jury makes virtually all the factual findings necessary to application of the scale, including the calculation of loss.³²

I will make only two observations on the broader topic of sentencing reform, pending discussion in Part IV about how to calibrate our scale. First, in cases of public company accounting fraud, jury application of mandatory sentencing guidelines, while avoiding constitutional obstacles, would be more fraught with problems than perhaps anywhere else in present criminal law. Under the United States Sentencing Guidelines, in a case like our Acme example, a jury would

made available").

³¹ See *United States v. Ebbers*, 458 F.3d 110, 127 (2d Cir. 2006) ("[R]evelation of an extended period of fraudulent financial statements may cause losses beyond that resulting from the restatement of financial circumstances because confidence in management and in even the truthful portions of a financial statement will be lost.").

³² See *United States v. Booker*, 543 U.S. 220, 245 (2005).

have to determine not just whether the government proved beyond a reasonable doubt every element of criminal securities fraud but many other issues including: how much the victims lost; by what method such loss should be calculated; the number of victims involved; whether the offense involved “sophisticated means;” whether the offense “substantially endangered the solvency or financial security” of a public company; whether the defendant was an “organizer or leader” of a criminal activity involving five or more persons; whether any victim was unusually “vulnerable;” whether the defendant obstructed justice in the course of the investigation or prosecution; and so on.³³

Complex white collar crime is already believed to be a serious challenge to the jury system.³⁴ Handing virtually the entire sentencing process in such cases to the jury would revolutionize trials of corporate crime, greatly complicating and lengthening them.³⁵ Of course, juries in civil securities fraud cases already confront problems of calculating loss for fraud on the market. However, far fewer civil than criminal cases proceed to trial; trials of civil cases do not burden the taxpayer nearly as much as criminal trials, in which one and sometimes both sides are publicly funded; and there is hardly evidence that civil juries in securities cases have been particularly adept at handling disputes over loss.

Second, it may not matter so much whether the scale for measuring seriousness of fraud is mandatory. Early data suggests that even though the Supreme Court has ruled that the Sentencing Guidelines are no longer binding,³⁶ federal judges have continued to follow them most of the time.³⁷ We can only speculate about whether this trend will

³³ See U.S. SENTENCING GUIDELINES MANUAL §§ 2B1.1(b)(1); 2B1.1 cmt. n.3; 2B1.1(b)(2); 2B1.1(b)(9); 2B1.1(b)(13)(B); 3B1.1(a); 3A1.1(b)(1); 3C1.1.

³⁴ See Pamela H. Bucy, *Moral Messengers: Delegating Prosecutorial Power*, 59 SMU L. REV. 321, 326 (2006).

³⁵ See Stephanos Bibas, *White-Collar Plea Bargaining and Sentencing After Booker*, 47 WM. & MARY L. REV. 721, 733 (2005) (“Proving fraud-on-the-market losses beyond a reasonable doubt may be all but impossible, particularly if sophisticated accounting arguments and maneuvers baffle lay jurors.”); see also Douglas A. Berman, *Tweaking Booker: Advisory Guidelines in the Federal System*, 43 HOUS. L. REV. 341, 370-71 (2006) (“[I]n any effort to draft [jury-applied] federal guidelines, lawmakers may find it hard to develop a comprehensive and yet simplified scheme for a complex federal system, and may also find it challenging to engineer an effective balance between firm rules and judicial discretion within any such sentencing structure.”). To be sure, the simpler any guidelines framework is, the more plausible is jury application of that framework. See Frank O. Bowman, III, *A Simplified Economic Crime Guideline: Model Sentencing Guidelines § 2B1*, 18 FED. SENT’G REP. 330, 335 (2006) (arguing for simplified loss table for economic crimes that would ease proof of loss before jury at trial). However, the more bare-bones is any guidelines framework, the less likely is it to treat like cases alike and different cases differently.

³⁶ See *Booker*, 543 U.S. at 245.

³⁷ See U.S. SENTENCING COMM’N, REPORT ON THE IMPACT OF *UNITED STATES V. BOOKER* ON FEDERAL SENTENCING, reprinted in 18 FED. SENT’G REP. 190, 192-93 (2006) (reporting that 85.9 percent of federal sentences since the Supreme Court’s decision in *Booker* have been in

continue and why it exists. Plausible explanations include that the Guidelines supply a focal point that judges use to reduce a coordination problem that contributed, at least in part, to inconsistencies in sentencing practices before the Guidelines; that a generation of federal judges grew comfortable with the Guidelines during nearly two decades of mandatory application; that judges do not want to be seen as departing from the Guidelines too frequently, for fear that Congress may pass new legislation that comports with the Supreme Court's rulings but revokes some of the judges' rediscovered sentencing discretion;³⁸ and that judges prefer to be detached, in the eyes of defendants, the public and even themselves from their sentencing decisions, which can inflict heavy damage on human lives.

Whether or not sentencing guidelines are binding law, principled, rational, proportional, and equality-based sentencing decisions are a consensus objective of society and within the legal system. It thus matters a great deal that we have a scale for measuring cases and that the scale be based upon the best available measure, whether or not application of the scale is mandated in an individual case.³⁹ In cases of financial statement fraud involving publicly traded companies, the best scale—with universal applicability, workability and grounding in the purposes of punishment in such cases—is total monetary loss to victims.

III. A METHODOLOGY FOR PLACING CASES ON THE SCALE

We have now begged the question how to measure loss to victims. In a routine case of fraud, this question can be easy. Suppose a devious antique dealer calls upon a naïve elderly person at her home and persuades her to sell him a unique chest of drawers—which he knows is worth \$100,000—by convincing her, through charm, lies and evidence of his expertise, that the chest is a cheap imitation worth only \$500. The victim's loss (and the offender's gain) is simply the difference between the actual value of the item and what the victim received: \$99,500.⁴⁰ Controlling for tangential facts that might alter the calculus

conformance with Guidelines (versus 91.9 percent in period immediately preceding *Booker*)).

³⁸ This prospect is all too familiar for the federal judiciary, following the recent experience with the Feeney Amendment to the PROTECT Act of 2003, Pub. L. No. 108-21, § 401, 117 Stat. 650, 675 (congressional effort to clamp down on judges' ability to depart from Guidelines, during the pre-*Booker* period when the Guidelines were mandatory).

³⁹ See Douglas A. Berman, *Distinguishing Offense Conduct and Offender Characteristics in Modern Sentencing Reforms*, 58 STAN. L. REV. 277, 291 (2005).

⁴⁰ I assume, of course, that the antique dealer is guilty of criminal fraud, which may be in question. Compare Roald Dahl, *Parson's Pleasure*, in KISS KISS 74 (1975) (delightfully describing a clear, fictional example of such fraud), with HOME OFFICE, FRAUD LAW REFORM: CONSULTATION ON PROPOSALS FOR LEGISLATION 10 (2004), available at

(the chest's sentimental value as a family heirloom, its special utility in storing the victim's sewing materials, the victim's desire to get the chest out of her house and so on), there is no doubt in this simple fraud case about either the amount of loss to the victim (\$95,500) or, more important, the causation relationship between the perpetrator's fraud and the victim's loss (1:1). In the accounting fraud case like our Acme example, however, the issues of loss amount and causation get thorny.⁴¹

This is where the law governing sentencing of corporate offenders has gone astray. In recent cases of major public company fraud, we have seen a confusing array of punishments, including: twenty-five years' imprisonment for an accounting fraud causing over one billion dollars in losses at Worldcom;⁴² twenty years' imprisonment for a several hundred million dollar accounting fraud at Adelphia;⁴³ fifteen years' imprisonment for an accounting fraud causing over \$100 million in investor losses at Homestore.com;⁴⁴ fifteen years' imprisonment for a \$300 million accounting fraud at American Tissue Inc.;⁴⁵ ten years' imprisonment for an accounting fraud causing billions of dollars in losses at Cendant;⁴⁶ eight and one-third to twenty years' imprisonment for looting of millions of dollars from Tyco;⁴⁷ three and one half years' imprisonment for an accounting fraud leading to hundreds of millions in losses at Impath;⁴⁸ probation for an accounting fraud causing \$400 million in losses at Healthsouth;⁴⁹ seven days' imprisonment for an accounting fraud causing over one billion dollars in losses at Healthsouth;⁵⁰ and, for the accounting fraud in the seminal Enron case, twenty-four years' imprisonment for the former CEO but only six years for the former CFO (whose sentence was fixed at ten years under a plea agreement but whom a judge nonetheless granted a further reduction for cooperation and remorse).⁵¹

<http://www.homeoffice.gov.uk> (type "fraud law reform" in search bar and click on the matching title noted above on the search results page) (using such a hypothetical in considering how to determine whether conduct constitutes fraud).

⁴¹ See Coffee, *supra* note 26, at 246.

⁴² See *United States v. Ebbers*, 458 F.3d 110, 129 (2d Cir. 2006).

⁴³ See Roben Farzad, *Jail Terms for 2 at Top of Adelphia*, N.Y. TIMES, June 21, 2005, at C1.

⁴⁴ See *Former Homestore.com CEO Sentenced to 15 Years for Plan to Inflate Revenues*, BNA CORP. ACCOUNTABILITY & FRAUD DAILY, Oct. 18, 2006.

⁴⁵ See *American Tissue Ex-CEO Sentenced to 15 Years in Prison in Fraud Case*, WALL ST. J. ONLINE, Sept. 25, 2006.

⁴⁶ See Floyd Norris, *Ex-Executive at Cendant is Sentenced to 10 Years*, N.Y. TIMES, Aug. 4, 2005, at C2.

⁴⁷ See Andrew Ross Sorkin, *Ex-Tyco Officers Get 8 to 25 Years*, N.Y. TIMES, Sept. 20, 2005, at A1.

⁴⁸ See *United States v. Adelson*, 441 F. Supp. 2d 506, 515 (S.D.N.Y. 2006).

⁴⁹ See *United States v. McVay*, 447 F.3d 1348, 1349 (11th Cir. 2006).

⁵⁰ See *United States v. Martin*, 455 F.3d 1227 (11th Cir. 2006); see also Kathleen F. Brickey, *Major Corporate Fraud Prosecutions, March 2002-February 2006* (on file with author) (in-progress tabulation of results in dozens of cases, some of which have reached sentencing stage).

⁵¹ See John R. Emshwiller, *Skilling Gets 24 Years in Prison*, WALL ST. J. ONLINE, Oct. 24,

To be sure, close analysis of these cases reveals plenty of relevant distinctions, including the extent of the frauds, the defendants' roles, the defendants' backgrounds and so on. But those differences do not appear to explain the huge disparities at the bottom line in what these courts have determined to be the appropriate severity of punishment for financial reporting fraud. Consider, for example, the recent sentencing of Sanjay Kumar, the high-profile former CEO of Computer Associates International (CA). Kumar presided over an elaborate effort to misreport over two billion dollars in revenue, by falsely booking income in quarters in which CA did not receive it, and concealed the accounting fraud and obstructed government investigations including by destroying evidence. The Sentencing Guidelines came out near the top of the scale, allowing for a sentence of life imprisonment without parole. In response, the sentencing judge abandoned the Guidelines entirely, settling on a sentence of twelve years' imprisonment and commenting that a sentence consistent with the Guidelines would "shock the conscience of this court."⁵²

Some of these disparities are surely due to judges' varying tolerance for the severity of the Guidelines, which I will explore in Part IV. But some of these result from the absence of a clear methodology for comparing cases on the question of loss, which is prior to the question of absolute sentence severity.

The bad news when we set out to improve the practice of measuring loss in financial reporting fraud cases is that fully accurate measurement of loss is difficult, perhaps not at all feasible.⁵³ The good news, however, is that we do not need a perfect method of measuring loss. We must remember why we care about loss. We are striving for horizontal equity across criminal cases, not optimal monetary sanctions in a program of civil liability. We need a relative measure, not an absolute one.

In this Part, I will first describe a variety of methodologies for handling loss and its relationship to causation. Then I will explain why a balance between being sufficiently sensitive to differences among cases and being practical a method that compares share prices during relevant periods before and after revelation of the fraud, with

2006, at C1; John R. Emshwiller & John M. Biers, *Fastow Gets Six Years As Judge Calls for Mercy*, WALL ST. J. ONLINE, Sept. 27, 2006, at A3.

⁵² See William M. Bulkeley, *Former CA Chief is Sentenced to 12-Year Prison Term, Fined*, WALL ST. J. ONLINE, Nov. 3, 2006, at A3. The sentencing judge who presided in Kumar's case, I. Leo Glasser, is neither novice nor softie; he is the senior district judge who presided over the trial of and sentenced mafia boss John Gotti.

⁵³ See *Basic, Inc. v. Levinson*, 485 U.S. 224, 255 (1988) (White, J., dissenting) (rejecting idea "that stocks have some 'true value' that is measurable by a standard other than their market price. While the Scholastics of Medieval times professed a means to make such a valuation of a commodity's 'worth,' I doubt that the federal courts of our day are similarly equipped.").

adjustment for major events unrelated to the fraud.

A. *Loss Methodologies*

Congress and the Sentencing Commission have been no help to courts faced with the task of determining loss in cases of financial reporting fraud. The Guidelines tell judges only (and only in their application notes) to “make a reasonable estimate of the loss.”⁵⁴ The court’s estimate

shall be based on available information, taking into account, as appropriate and practicable under the circumstances, factors such as . . . fair market value . . . approximate number of victims multiplied by the average loss to each victim . . . [and] reduction that resulted from the offense in the value of equity securities or other corporate assets.⁵⁵

In a significant case of accounting fraud, our question of methodology for calculating loss is still begged—notwithstanding the Sentencing Commission’s perplexing statement that its recent direction to consider reduction in a company’s equity value “provide[s] courts additional guidance in determining loss in certain cases, particularly in complex white collar cases.”⁵⁶ This absence of guidance is an abdication of responsibility.⁵⁷

“Market Capitalization” Approach. The simplest method for calculating loss in an accounting fraud case is to measure the difference between the company’s share price before revelation of the fraud and the company’s share price at some relevant time following disclosure of the fraud. This method assumes that any, and all, drop in equity value following revelation of the fraud is caused by the fraud. In other words, it disregards causation. In our Acme case, the loss would be \$800 million (the difference between twenty million shares at sixty dollars per share and twenty million shares at twenty dollars per share), if we chose to examine the initial five-day period of sharp decline following the fraud revelation on July 1, 2005. If we instead chose the longer period of price decline continuing until December 31, 2005, the loss would be one billion dollars (the difference between twenty million shares at sixty dollars per share and twenty million shares at ten dollars per share).⁵⁸

⁵⁴ U.S. SENTENCING GUIDELINES MANUAL § 2B1.1 cmt. n.3(C).

⁵⁵ *Id.* § 2B1.1 cmt. n.3(C)(i)-(iv).

⁵⁶ U.S. SENTENCING GUIDELINES MANUAL app. C (vol. II) (2003) (Amendment 653, at 365).

⁵⁷ See Bibas, *supra* note 35, at 734 (“[T]he Sentencing Commission should clarify how to compute losses in areas that are currently murky, such as the large accounting-fraud cases premised on drops in a stock’s price.”).

⁵⁸ See, e.g., *United States v. Snyder*, 291 F.3d 1291, 1295-96 (11th Cir. 2002) (reversing

This method, which has been described as the “market capitalization test,”⁵⁹ fails to satisfy even the “any reasonable method” direction of the application notes to the Guidelines. Not all of Acme’s shareholders bought at \$60 and held the stock throughout the period of declining price following revelation of the fraud.⁶⁰ The method measures maximum possible loss, not actual loss.⁶¹ Worse, the method simply assigns all of Acme’s share price decline to the revelation of the fraud without inquiry into actual causation, which would have to include consideration of other factors that could have affected share price.⁶²

Not surprisingly, the Fifth Circuit Court of Appeals reversed a judge who applied a method like this one, in *United States v. Olis*.⁶³ The case attracted public attention because of the draconian sentence (twenty-four years’ imprisonment) imposed on a mid-level accounting official with no record of misdeeds who helped implement a single fraudulent transaction designed to improve the financial picture of an energy firm, Dynegy Corporation.⁶⁴ The district court found that the

district court for abandoning loss calculation as not feasible and remanding for resentencing; observing that one acceptable method would measure the difference in market capitalization between (1) the share price’s average in the period from a press release falsely touting the company’s medical product as “effective” to the company’s announcement that the product was not effective and (2) the average share price during the three days following the announcement of the fraud, notwithstanding that the share price later rallied to a price significantly higher than (1).

⁵⁹ *United States v. Ebbers*, 458 F.3d 110, 127 (2d Cir. 2006).

⁶⁰ *See United States v. Bakhit*, 218 F. Supp. 2d 1232, 1237 (C.D. Cal. 2002).

⁶¹ One might further complain that even shareholders who bought at sixty dollars per share just before the fraud began are not harmed by the fraud, since revelation of the company’s problems immediately after those investors’ purchases, instead of managers’ pursuit of fraud, would have caused the same price decline. However, this point is not quite persuasive. Almost all accounting frauds cause harm over an extended period. There are many points during the fraud period at which managers’ pursuit of fraud can be said to cause purchasers to forego the opportunity to limit losses by selling. And information that managers would pursue fraud likely reduces the value of a company’s securities in the eyes of investors beyond any negative financial information that a fraud concealed. *See Ebbers*, 458 F.3d at 127.

⁶² One court rejected a similar theory in the context of an initial public offering (IPO) that involved fraudulent representations. *Bakhit*, 218 F. Supp. 2d at 1236-37. In *Bakhit*, it was argued that the loss should equate to the entire proceeds of the IPO because the offering was made on false terms. The court declined to follow that reasoning on the ground that the venture had value notwithstanding the fraud, as evidenced by its survival after the fraud’s revelation. *Id.*; *see also Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 343 (2005) (“[a subsequent] 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”); *Ebbers*, 458 F.3d at 127 (the problem with “simplistic analysis” of market capitalization is that “[i]f the truth had been told [at the outset of the fraud, shareholders] would have suffered an immediate loss commensurate with the fraud loss because potential buyers at the earlier price would have immediately disappeared upon the bad news”).

⁶³ 429 F.3d 540 (5th Cir. 2005).

⁶⁴ *See, e.g., John Gibeaut, Do the Crime, Serve More Time: Midlevel Dynegy Exec Feels the Brunt of New Guidelines*, 13 A.B.A. J. E-REP., Apr. 2, 2004, at 1; Mike France, *How Broken Is White Collar Justice?*, BUS. WK., Apr. 5, 2004.

loss was at least \$100 million, requiring a twenty-six level increase in the defendant's Guidelines level, solely because a representative of a large institutional investor testified that his fund lost \$105 million when Dynegy's share price declined in the period after revelation of the fraud.⁶⁵

The Court of Appeals explained that sentencing judges must employ a "realistic, economic approach" to determining losses and explained that methods for measuring civil damages for securities fraud should form a "backdrop" to determining criminal responsibility.⁶⁶ Because the Supreme Court, in *Dura Pharmaceuticals, Inc. v. Broudo*,⁶⁷ recently clarified the requirement of "loss causation" in civil securities cases, the Fifth Circuit said, sentencing courts may not find that there has been loss to shareholders "unless and until the truth is subsequently revealed and the price of the stock accordingly declines;" additionally, a sentencing court may not include price decline in a loss calculation "[w]here the value of a security declines for other reasons."⁶⁸ The Fifth Circuit acknowledged that a satisfactory loss methodology in criminal sentencing could be "less exact" than in civil litigation due to "time and evidentiary constraints on the sentencing process," but the court rejected the market capitalization approach of the district court in *Olis*.⁶⁹ The court remanded the case for the sentencing court to pursue "a more nuanced approach modeled upon loss causation principles."⁷⁰

"Earnings Response Coefficient" and Intra-Period Shares. A more rigorous method might be to develop a measure of the sensitivity of a company's stock price to earnings announcements. One might examine only those earnings announcements that were "clean" (not accompanied by other significant information that might affect price) and that varied from published forecasts or expectations about the company's performance, in order to derive a coefficient measuring the amount by which the company's stock price should be predicted to

⁶⁵ *Olis*, 429 F.3d at 548.

⁶⁶ *Id.* at 546 (quoting *United States v. W. Coast Aluminum Heat Treating Co.*, 256 F.3d 986, 991 (9th Cir. 2001)).

⁶⁷ 544 U.S. 336 (2005).

⁶⁸ *Olis*, 429 F.3d at 546; *see also* *United States v. Ebbers*, 448 F.3d 110, 127-28 (2d Cir. 2006). "Loss causation" requires more than but-for causation, otherwise a shareholder could always recover for all losses incurred from investing in the stock on the argument that she would not have purchased the stock in the first place but for the defendant's fakery. *Bowman, III, supra* note 22, at 524.

⁶⁹ *Olis*, 429 F.3d at 547.

⁷⁰ *Id.*; *see also* *United States v. Bakhit*, 218 F. Supp. 2d 1232, 1238-39 (C.D. Cal. 2002) (rejecting market capitalization approach to calculating loss because many shareholders purchased at prices lower than the immediate pre-revelation price and because approach does not account for intervening causes of share price decline unrelated to the fraud). For appellate decisions appearing to approve the market capitalization approach to calculating loss (on facts too sketchy to permit assessment of the decisions), *see United States v. Eymann*, 313 F.3d 741 (2d Cir. 2002); *United States v. Moskowitz*, 215 F.3d 265 (2d Cir. 2000).

move in response to a given amount of variation between predicted and actual reported earnings. (This is like a price-earnings multiple but for *variation* between actual earnings and earnings as forecast.) One would then multiply the percentage of earnings change represented by the accounting fraud by this “earnings response coefficient” to derive the corresponding percentage change in share price. Last, one would multiply that share price percentage by the total number of shares purchased during the fraud and held beyond the fraud’s disclosure, in order to derive total loss to victims.

Suppose in our Acme case that a study of five years of earnings announcements by Acme revealed six occasions on which Acme reported earnings inconsistent with published forecasts and on which no other public information significantly affected Acme’s stock price. Over the six occasions on which Acme missed forecasts, Acme’s stock rose or fell by an average of twenty percent of the amount by which Acme’s earnings deviated from what was forecast. Suppose further that eight million shares of Acme were bought between January 1, 2005 and July 1, 2005 (the period of the fraud) and held after the revelation of the fraud (after July 1, 2005). Assume that the one billion dollars by which debt increased following revelation of the fraud represented a twenty percent increase in Acme’s debt load. We would multiply that twenty percent reporting change by the twenty percent “earnings response coefficient,” to arrive at a four percent change in Acme’s stock price attributable to the fraud. The decline in Acme’s share price attributable to the fraud, and not to other factors affecting the stock, is thus \$2.40 (four percent of the pre-revelation share price of sixty dollars). With eight million shares affected by \$2.40 per share, the total loss attributable to the fraud is \$19,200,000.⁷¹

This approach has a number of problems. The most obvious issue in the Acme example is that the accounting fraud is related to debt, not to earnings. For fraud in financial reporting other than inflated earnings numbers (for example, matters relating to a company’s debt, its business segment reporting, or its business prospects and plans), a company’s past “earnings response coefficient” tells us little if anything about the relationship between the fraud and the ensuing movement in the company’s share price. We might even lack the necessary baseline to calculate the coefficient if, for example, the company had no recent history of missing earnings expectations. Also, what if some mix of factors unrelated to the fraud causes a company’s share price to *rise* following revelation of the fraud? Would we still apply the “earnings response coefficient” to derive a notional loss figure measuring the

⁷¹ The government unsuccessfully urged this methodology on the court, through testimony of an expert witness, in *United States v. Grabske*, 260 F. Supp. 2d 866 (N.D. Cal. 2002).

seriousness of the fraud, or would we punish the fraud as having a seriousness level of zero because no actual loss occurred? What if the stock price fell following revelation of the fraud but then bounced back relatively quickly? The “earnings response coefficient” approach is appealingly sophisticated in relation to the market capitalization approach but it insufficiently represents the reality of causation in financial reporting fraud.

Expert “Event Studies.” A more fact-sensitive approach would be to allow the prosecution and the defense to present expert testimony describing “event studies,” under which experts attempt to identify and assign relative weights to all factors that could have caused change in a company’s stock price during the period following revelation of the fraud. The proportion of price change attributable to the fraud would then be isolated, and the loss calculated according to the number of affected shares.⁷²

We need not explore the limitless variety of methodologies, many involving regression and other statistical techniques, that experts might employ in conducting such event studies. Criminal sentencing is post-trial litigation, not empirical research. The only sure thing in a process of event studies is that there will be at least two experts in every case who arrive at widely varying loss numbers on the basis of different methods involving choices and assumptions subject to criticism. In each case, a judge will have to decide which expert is more persuasive.⁷³ (Or a judge could simply conduct a seat-of-the-pants judicial event study.)⁷⁴ The objective of having a systematic

⁷² See, e.g., *United States v. Bakhit*, 218 F. Supp. 2d 1232, 1239 (C.D. Cal. 2002) (defendant’s expert netted losses of some shareholders against gains of others, then determined that fraud was responsible for only 17.47% of the company’s decline in share value while other factors such as bookkeeping mistakes caused remainder of decline); see also *United States v. Brown*, 338 F. Supp. 2d 552, 558 (M.D. Pa. 2004) (defendant’s expert concluded by means of an event study that loss to shareholders from accounting fraud involving Rite Aid corporation was zero); *United States v. Adelson*, 441 F. Supp. 2d 506, 510 (S.D.N.Y. 2006) (defendant’s expert concluded that estimating loss from fraud was impossible because too many “confounding factors” simultaneously affected company’s share price).

⁷³ See, e.g., *Akerman v. Oryx Comm., Inc.*, 810 F.2d 336, 343 (2d Cir. 1987) (granting summary judgment for defendant in suit brought under section 11 of the Securities Act of 1933 over misstatement in initial public offering, on ground that “the battle of the [expert loss] studies is at best equivocal; the studies do not meaningfully point in one direction or the other”). Section 11 of the Securities Act of 1933 permits a plaintiff to recover damages calculated under the market capitalization test discussed *supra*, subject to reduction for losses not attributable to any misstatement in the public offering materials, on which the defendant bears the burden of proof. See 15 U.S.C. § 77k(e) (2006).

⁷⁴ The *Adelson* court did this, concluding that the defendant was responsible for twenty percent of the stock decline following revelation of the fraud because that was “the Court’s rough approximation based on the modest extent of the actual overstatements [of earnings] in the context of the public loss of confidence in [the company’s] future that had already led to a large decline in share price even before [the defendant] joined the conspiracy.” *Adelson*, 441 F. Supp. 2d at 510; see also *Beecher v. Able*, 435 F. Supp. 397, 406 (S.D.N.Y. 1977) (in civil suit for

methodology for organizing fraud cases relative to each other on a single scale will be lost.⁷⁵ Worse, the relative resources of the parties in a given case could determine whose expert event study prevails. In addition, the process of litigating expert analysis of loss could mire courts in lengthy and complicated sentencing proceedings that are inconsistent with objectives of efficiency and finality in post-trial criminal adjudication.⁷⁶

Consider what happened in the *Olis* case on remand from the Fifth Circuit.⁷⁷ The government's expert submitted a highly elaborate event study, including complex regression analyses. The expert concluded that the loss to Dynege's investors "net of market" following revelation of the fraud (booking of \$300 million as cash flow from operations when truthfully it was borrowed funds)⁷⁸ was between \$161 million and \$714 million, depending on a series of choices about which periods to examine and how much weight to ascribe to various events unrelated to the fraud.⁷⁹ In response, the defendant submitted an analysis by an expert who argued—by examining the market's reaction to disclosures about the fraud in the few days following each disclosure, coupled with Dynege's simultaneous disclosures of other adverse information not involving fraud—that the government's analysis failed to establish that *any* decline in Dynege's stock price was caused by revelation of the fraud.⁸⁰ The defense expert contended that the government also failed to establish any inflation in Dynege's stock price from the fraud because the stock did not rise in value when Dynege initially filed financial statements that included the fraudulent numbers.⁸¹

Faced with this contest of experts, the district court threw up its hands. The court concluded that because the government's expert analysis depended on "unprovable assumptions . . . it is not possible to estimate with any degree of reasonable certainty the actual loss to

materially false offering prospectus under section 11 of Securities Act of 1933, court conducted elaborate loss analysis that included conclusions that, *inter alia*, "defendant's financial difficulties were balanced off by the defendant's probable recovery" and "[t]o correct for [the] aberration [of "panic selling"], the court adds 9 1/2 points to the market price of 75 1/2 to establish a figure of 85 as fair value on the date of suit").

⁷⁵ See *Grabske*, 260 F. Supp. 2d at 874; *Bakhit*, 218 F. Supp. 2d at 1240; *Brown*, 338 F. Supp. 2d at 558.

⁷⁶ See THOMAS LEE HAZEN, LAW OF SECURITIES REGULATION § 12.12[1] (5th ed. 2005) ("Theoretical models [of fraud loss], while useful to economists, may not be sufficiently based in reality to provide helpful expert testimony [as required by the Supreme Court's decision in *Daubert v. Merrell Dow Pharm., Inc.*, 509 U.S. 579 (1993)].").

⁷⁷ United States v. *Olis*, No. H-03-217-01, 2006 WL 2716048 (S.D. Tex. Sept. 22, 2006).

⁷⁸ See United States v. *Olis*, 429 F.3d 540, 541 (5th Cir. 2005).

⁷⁹ See *Olis*, 2006 WL 2716048, at *4-8.

⁸⁰ See Declaration of Professor Joseph A. Grundfest, United States v. Jamie *Olis*, Cr. No. H-03-217 (S.D. Tex. Aug. 18, 2006), at 13-34 (on file with author).

⁸¹ See *id.* at 9-13.

shareholders caused by the corrective disclosures about [the fraud].”⁸² The court instead settled on a loss figure of seventy-nine million dollars, which was the amount of tax savings the Dynege perpetrators intended the company would also realize from its accounting maneuver. The court recalculated the Guidelines range at 151 to 188 months, and then sentenced Olis to less than half of the bottom of the range (seventy-two months’ imprisonment), on the ground that no more punishment was necessary for general deterrence.⁸³ Regardless of whether Olis deserved his original sentence of twenty-four years, his ultimate sentence of six years or some other sentence, Dynege’s tax savings, while more easily quantified, hardly represented the gravamen of the accounting fraud for which Olis was convicted at trial.

The sentencing court in *Olis* was not called upon to determine whether to compensate individuals who purchased Dynege stock during the time the company was improperly burnishing its cash flow and minimizing its debt and lost money later. The court had to determine the seriousness of the Dynege accounting fraud relative to other frauds. “The causation story is just too complicated to work out” (and therefore the case should be treated as if it involved *no loss* to investors) is not an acceptable stopping point for a sentencing court.

While the *Olis* court insisted that it was not concluding “that such estimates are never possible,”⁸⁴ it is hard to see how litigants in virtually any case of accounting fraud would not be equally able to confound a sentencing court. Hard cases of causation with convincing defense experts get punished less; easy cases of causation with less convincing defense experts get punished more. We are back to the problem of a sentencing system that treats like cases differently according to nonrelevant distinctions. Yet such a result seems almost inevitable (except perhaps for catastrophic cases like Enron or Worldcom) if we depend on the event study approach and insist that it meet a standard of “reasonable certainty” in all its statistical particulars.

“*Foreseeability*” Approach. A somewhat similar methodology to an event study, but more wedded to familiar concepts in criminal law and sentencing law, would be to determine the amount of loss that was “foreseeable” to the defendant.⁸⁵ (The Guidelines partially follow this approach by placing a ceiling on the calculation of “actual loss” at what was “reasonably foreseeable” to the defendant.)⁸⁶ For example, one might calculate the total ensuing loss to victims under something like

⁸² *Olis*, 2006 WL 2716048, at *8.

⁸³ *Id.* at *10-13.

⁸⁴ *Id.* at *9.

⁸⁵ See, e.g., Bowman, III, *supra* note 22, at 532-36 (recommending rule requiring foreseeability in calculation of loss for all forms of economic crime).

⁸⁶ U.S. SENTENCING GUIDELINES MANUAL § 2B1.1 cmt. n.3(A)(i).

the market capitalization method and then reduce that amount to the portion deemed foreseeable to the defendant (or perhaps *increase* the amount by what the reasonable defendant would have expected if, fortuitously, loss was avoided). This method does not improve on the event study approach in terms of requiring sentencing courts to make ad hoc determinations about which strands in a tangle of economic effects should affect a sentence and which should not. The two methods might lead to the same battle of experts, since a litigant likely would argue that the “foreseeable” loss is whatever portion of the loss is properly attributed, in the view of her expert, to the defendant’s fraudulent acts rather than other market factors.

PSLRA, aka “Average Selling Price” or “Rescissory” Approach. Congress recently has spoken on the question how to calculate loss in securities fraud cases, albeit not in the criminal context. The Private Securities Litigation Reform Act provides, in pertinent part, that:

the award of damages to the plaintiff shall not exceed the difference between the purchase or sale price paid or received, as appropriate, by the plaintiff for the subject security and the mean trading price of that security during the 90-day period beginning on the date on which the information correcting the misstatement or omission that is the basis for the action is disseminated to the market.⁸⁷

One court applying a methodology like this in a criminal sentencing called it a “rescissory measure” of loss because the process calculates loss according to what would be necessary to return the victim to the same position she occupied before the fraud induced her to purchase, sell or hold the company’s security.⁸⁸

To apply this approach in our Acme example, we would calculate the average price of the stock during the period of the fraud (January 2, 2005 to July 1, 2005) (let’s call this the “average fraud price”) and the average price of the stock during the ninety-day period following disclosure of the fraud (let’s call this the “average post-fraud price”). We would subtract the average post-fraud price from the average fraud price to derive the loss per share. We then would multiply the loss per share by the number of affected shares to derive the total loss figure. If Acme’s average fraud price was fifty-five dollars, Acme’s average post-

⁸⁷ 15 U.S.C. § 78u-4(e)(1) (2006).

⁸⁸ *United States v. Grabske*, 260 F. Supp. 2d 866, 872 (N.D. Cal. 2002) (relying on *In re Mego Fin. Corp. Sec. Litig.*, 213 F.3d 454 (9th Cir. 2000)); *see also* *Pidcock v. Sunnyland Am., Inc.*, 854 F.2d 443, 446 (11th Cir. 1988) (in civil suit for fraud by purchaser of securities, seller is entitled to what seller would have received absent fraudulent conduct; if purchaser gains more than seller’s loss, seller is entitled to purchaser’s profits because “it is simple equity that a wrongdoer should disgorge his fraudulent enrichment”) (quoting *Janigan v. Taylor*, 344 F.2d 781, 786 (1st Cir. 1965)); *HAZEN*, *supra* note 76, § 12.12[2] (“When the essence of the plaintiff’s claim is fraud in the inducement—namely, that he or she would not have entered into the transaction but for the defendant’s fraud, rescission is arguably the proper measure of damages.”).

fraud price was thirty dollars, and the number of affected shares was eight million, then the loss amount for Guidelines purposes would be \$200 million.⁸⁹

This method has been described as “rescissory” because its choice to ignore other factors that may have contributed to the decline in share price during the ninety-day period following revelation of the fraud is justified on the ground that the injured party is entitled to be put back in the position she occupied before disclosure of the fraud.⁹⁰ Obviously, making victims whole is the business of damages, not imprisonment. But in criminal cases we must weigh the objective of measuring relative blameworthiness with exactitude against the objectives of practicality in sentencing proceedings and uniformity of methodology across the range of cases of financial reporting fraud.⁹¹ The method thus has appeal even if it is rough.

We could compromise between the PSLRA and event study approaches. For example, suppose that a company announced a \$500 million restatement of earnings, \$250 million of which was due to correction of fraudulent accounting and \$250 million of which was due to errors or other factors not involving fraud. The loss figure attributable to the fraud might be fifty percent of the difference between the average fraud price and the average post-fraud price.⁹² Of course, this method again stumbles in any case in which the fraud involves conduct not strictly quantifiable as overstated income or understated losses. In addition, the method assumes that restated earnings results correlate directly with decreased share price rather than considering, for example, whether the market punished the stock more for the fraud than for the errors unrelated to the fraud because the fraud communicated important information about management integrity.

A frequent objection to a PSLRA-type approach, as well as to other methods of calculating loss from fraud on the market, is that the method overstates losses because many shareholders *profit* from the fraud—for example, by purchasing shares before the fraud, holding them while they are inflated by the fraud, and selling them before they

⁸⁹ This method was employed by the district courts in *United States v. Brown*, 338 F. Supp. 2d 552 (M.D. Pa. 2004); *Grabske*, 260 F. Supp. 2d at 866; and *United States v. Bakhit*, 218 F. Supp. 2d 1232, 1232 (C.D. Cal. 2002).

⁹⁰ See *Grabske*, 260 F. Supp. 2d at 874. The method has also been described as the “Average Selling Price Methodology.” *Brown*, 338 F. Supp. 2d at 557.

⁹¹ See *Grabske*, 260 F. Supp. 2d at 874-75; see also *Bakhit*, 218 F. Supp. 2d at 1242 (“[T]he district court need not find a perfect theoretical model to calculate loss, only a realistic, economic approach.”).

⁹² The court applied this method in *Brown*, 338 F. Supp. 2d at 557-58. In addition, the *Brown* court subtracted from the loss amount an eleven-cent dividend to shareholders during the relevant period and, in calculating the number of affected shares, it “split[] the difference” between the high and low ends of what the defendant’s expert estimated as the range of quantity of potentially affected shares. *Id.* at 558-60.

decline in value upon revelation of the fraud.⁹³ A variation on this objection is that sanctions levied against the enterprise in civil securities cases involving fraud on the market can be wasteful and ineffective, by transferring wealth from one group of winning shareholders to another group of losing shareholders.⁹⁴ A further point is that even sanctioning individual violators may be a mistaken response to something that is not a social cost, given that the diversified investor will, on a net basis over time, be neither a winner nor a loser from fraud.⁹⁵

There are answers to these objections, including that some such arguments prove too much to be plausible (e.g., fraud is as beneficial as it is harmful so it need not be deterred?).⁹⁶ But we should not be detained by theoretical debate over optimal civil sanctions for securities fraud.⁹⁷ We are striving for proportionality and rationality in criminal sentencing. The Sentencing Guidelines make clear that netting some people's gains against others' losses in a fraudulent scheme is not appropriate in measuring the seriousness of fraud for criminal purposes. (The Sentencing Commission uses the example of how early victims may gain in a Ponzi scheme).⁹⁸ The Second Circuit also has expressed this view.⁹⁹

The Commission and the Second Circuit are right. In measuring loss for purposes of punishing criminal securities fraud, we are determining the *relative* seriousness of a form of wrongdoing we have decided to prohibit in service of retributive and deterrent aims of criminal punishment, not measuring how to make victims whole or determining the optimal level of fraud to tolerate.¹⁰⁰ If, as discussed in

⁹³ See STEPHEN J. CHOI & A.C. PRITCHARD, *SECURITIES REGULATION: CASES AND ANALYSIS* 348 (2005).

⁹⁴ See, e.g., Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1991 U. ILL. L. REV. 691.

⁹⁵ See Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 611, 640-41 (1985); see also Richard A. Booth, *Who Should Recover What for Securities Fraud?* (Dec. 2005) (working paper), available at http://digitalcommons.law.umaryland.edu/cgi/viewcontent.cgi?article=1011&context=fac_pubs.

⁹⁶ See RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 459-60 (6th ed. 2003) (imposing sanctions for fraud on the market provides incentive to monitor managers to prevent fraud, even if costs are borne by "innocent" shareholders; fraud on the market imposes social costs including increased costs to all investors of acquiring truthful information about firms).

⁹⁷ For a recent summary and analysis of the debate, see Larry E. Ribstein, *Fraud on a Noisy Market* (Univ. of Ill., Law & Econ. Research Paper No. LEO5-022), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=803064.

⁹⁸ U.S. SENTENCING GUIDELINES MANUAL § 2B1.1 cmt. n.3(F)(iv) ("[G]ain to an individual investor . . . shall not be used to offset the loss to another individual investor.").

⁹⁹ See *United States v. Ebbers*, 458 F.3d 110, 126 (2d Cir. 2006).

¹⁰⁰ See Easterbrook & Fischel, *supra* note 95, at 621-22 (suggesting that there is no efficient level of deliberate fraud); see also *Holmes v. Sec. Investor Prot. Corp.*, 503 U.S. 258, 270-71 (1992) (conducting careful proximate cause inquiry in determining who may sue for damages under RICO for losses caused by securities fraud; finding link too remote between broker-dealers and customers who did not purchase fraudulent products but were harmed by broker-dealers' fraud).

Part II, the seriousness of a criminal fraud on the market is primarily a function of the quantity of investor trust a manager held and violated, then the quantity of investor losses is a good measure of seriousness, regardless of whether other fortunate investors (including in many cases managers) happened to profit from the fraud.

B. Preferred Loss Methodology

Adherence causation principles dictate that the measure of loss for sentencing purposes, like the measure of damages in a civil suit for securities fraud, be calculated as the difference between what the seller or buyer received and what the seller or buyer would have received had there been no fraudulent conduct.¹⁰¹ However, empirical limitations of the litigation process, demands of efficiency, clarity, finality and uniformity in the sentencing process, and the impetus to avoid burdening the public fisc with expensive and often inconclusive expert contests in criminal cases necessitate compromising some precision.¹⁰² The trick is to find an adequate methodology between a case-specific event study and a grossly inaccurate approach like market capitalization. The objective is *not* to derive absolute truth about the seriousness of a particular case. Nor is it, as in a civil suit for securities fraud, to make victims whole for all of (and no more than) their actual dollar losses. Nor is it (at least not only) to regulate fraud to the efficient level. The objective is to effectively arrange cases along a scale *in relation to each other*, without failing to account for major relevant distinctions among them.¹⁰³

The PSLRA method fares well, provided we modify it to allow for important case-specific factors that are observable and quantifiable with market data and without the use of elaborate and contestable methods.¹⁰⁴ Loss for purposes of a criminal sentence in a case of

insolvency resulting from fraud).

¹⁰¹ See *Pidcock v. Sunnyland Am., Inc.*, 854 F.2d 443, 446 (11th Cir. 1988) (citing *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 155 (1972)).

¹⁰² See *United States v. Bakhit*, 218 F. Supp. 2d 1232, 1242 (this method “is based upon objective trading data, easily obtained, that minimizes the speculation”).

¹⁰³ See *Holmes*, 503 U.S. at 268 (describing proximate cause as “the judicial tools used to limit a person’s responsibility for the consequences of that person’s own acts . . . [T]he notion of proximate cause reflects “what is . . . administratively possible and convenient.”) (quoting W. KEETON, D. DOBBS, R. KEETON & D. OWEN, *PROSSER AND KEETON ON LAW OF TORTS* § 41, at 264 (5th ed. 1984)).

¹⁰⁴ To be sure, there are reasons for distinguishing the process of assessing civil damages from the process of imposing criminal punishment. See *United States v. Mooney*, 425 F.3d 1093, 1101 (8th Cir. 2005) (rejecting loss method for determining sentence in insider trading case that would have pursued complicated inquiry into when market fully absorbed nonpublic information); *id.* at 1107 (Bright, J., dissenting) (loss method based on difference between defendant’s purchase price

financial statement fraud should be determined as follows: Calculate the average share price during the period from the commencement of the fraud until the last day before first public revelation of any aspect of the fraud (the average fraud price); calculate the average share price during the ninety days following the first date of public revelation of any aspect of the fraud (the average post-fraud price); estimate as accurately as possible the total number of shares that were purchased between the commencement of the fraud and the first date of public revelation of any aspect of the fraud *and* that were held at least until the first date following first public revelation of the fraud (the affected shares);¹⁰⁵ finally, subtract the average post-fraud price from the average fraud price and multiply by the number of affected shares to derive an initial total loss figure.

A complication at this stage of this analysis might be uncertainty over the time of first public revelation of the fraud. Suppose in our Acme example that four weeks before CEO held the July 1, 2006 conference call announcing the earnings corrections, a magazine that covers Wall Street ran a cover story on Acme's accounting practices, headlined "Are Acme's Numbers Reliable?" and raising questions about the company's off-balance-sheet structures. In the Acme hypothetical as given, we would be unlikely to ascribe significance to that article because the stock price did not decline prior to CEO's July 1 announcements. But what if the article had made investors skittish about Acme and the stock had slipped a bit in the wake of its publication?

It would seem prudent to begin counting equity decline from the point of the first public allegation of the *same* fraud that later resulted in a criminal case. The point is not to punish for the effect of rumors; if early speculation later proved groundless, there would be no criminal case requiring loss analysis. If, however, the market begins to bid the stock down before a company representative (or a prosecutor or a court) finally and definitively states "this was a fraud," excluding that loss would defeat the object of treating cases equitably. A case's seriousness would hinge fortuitously on how and when the fraud was

and defendant's later sale price (as opposed to difference between defendant's purchase price and true value of stock on date of purchase) means that multiple defendants who commit "the same crime" by purchasing on same date on basis of same nonpublic information end up with different sentences if they happen to sell on different dates). However, the PSLRA method is not complicated, it does capture blameworthiness (the more investor funds placed in jeopardy, the worse the accounting fraud) and there are also benefits, in terms of the development of doctrine, in having similar approaches to loss applied in both civil and criminal cases.

¹⁰⁵ In the interest of brevity, I will not explore in depth methodologies for estimating quantity of affected shares. It does not matter greatly if courts use a method that may tend to overestimate quantity, as long as all use the same method. Any such systematic effects can be corrected for in calibrating the loss scale as discussed in Part IV.

revealed, rather than the fraud's severity, and an even greater than existing incentive would develop for company managers to deny and bleed out information about fraud rather than quickly to come clean.

Next, it would be simple and sensible to adjust in all cases for a stock's "beta." The basic capital asset pricing model measures a stock's historical return rate in relation to the historical return rate of the market, where a beta of 1.0 means that a stock moves ten percent when the market moves ten percent; a beta of .5 means a stock moves five percent when the market moves ten percent; a beta of 2.0 means a stock moves twenty percent when the market moves ten percent; and so on.¹⁰⁶ We thus would determine the stock's beta, calculate how much the market moved during any period in which we are measuring movement in the stock for loss purposes, and adjust the change in price during that period with reference to the stock's beta.¹⁰⁷

Last, the method should allow for a measure of discretion. In cases in which an event unrelated to the fraud plainly caused a significant change in share price, either during the fraud or in the period after revelation, the court should modify the loss figure. Let's supplement our Acme case with a complicating fact about causation. Suppose that the same day CEO held the conference call with Wall Street disclosing the accounting fraud, the press reported that the Federal Communications Commission (FCC) was considering imposing a new ratings system for broadcasts to cell phones, designed to protect children, that could substantially delay and complicate industry plans to implement this technology. On December 30, 2005, the press reported that the FCC had voted to abandon the new ratings initiative. Recall that Acme's stock declined from sixty to twenty dollars between revelation of the fraud and December 31, but rebounded to thirty dollars after December 31.

We need a transparent and relatively objective method of accounting for these events, even if it might be somewhat rough. The best way to ensure transparency and objectivity is to keep calculations simple and tied to market data. We could deal with the FCC information by noting that the stock rebounded to thirty dollars following elimination of the risk of delay and complications upon the FCC vote. We thus would set thirty dollars as a floor in calculating the average post-fraud price. If we did this, the average post-fraud price might turn out to be approximately forty-five dollars (the mid-point

¹⁰⁶ See CHOI & PRITCHARD, *supra* note 93, at 22-23.

¹⁰⁷ Suppose that a company's stock moved downward from \$100 to eighty dollars (by twenty percent) in the ninety days following the fraud; that the company's average stock price during those ninety days was ninety dollars; that the market also moved downward by twenty percent during those ninety days; and that the company's beta is .5. The average post-fraud price in such a case would be ninety-five dollars.

between sixty and thirty dollars), rather than forty dollars (the mid-point between sixty and twenty dollars). The result in the Acme case, assuming an average fraud price of fifty-five dollars, an average post-fraud price of forty-five dollars, and eight million affected shares, would be a final loss figure of eighty million dollars.

What about harder cases in which, for example, two pieces of information apt to depress the stock price, only one of which involved fraud revelation, hit the market simultaneously, so that we cannot isolate the fraud effects by examining only certain days of price activity? The sentencing stage is not reached without a jury's finding of materiality (or an admission thereof).¹⁰⁸ It is not without justification to say the offender who inflated (or artificially propped up) the stock is responsible for the consequential harm to all investors who purchased the stock in reliance on the offender's lies. And a rule that the presence of confounding causes should lead to a finding of *no* loss would provide a strong incentive to bury fraud revelations in release of other information designed to complicate causation inquiry.¹⁰⁹

The government must prove that the defendant caused the loss a court uses to enhance punishment. But there needs to be a workable procedure for unpacking a case of simultaneous causes, so that confounding causation does not equate to zero causation. We might allow a limited role for expert event analysis—solely to establish, in cases of simultaneous causes not of obviously different weights, a greater likelihood than not that the fraud caused approximately half the loss. Application of such a standard across cases would serve the goal of horizontal equity far better than a practice in which some portion of cases involving multiple causes were treated as if they were cases of no loss.

Finally, what about the problem of the offender who has a relatively small role in a large fraud, or enters the scheme relatively late? Should all participants in a fraud scheme bear the same loss figure for sentencing purposes, or should we discount the loss figure for reduced culpability? The Sentencing Guidelines have long followed a general approach (not just with economic crimes) of ascribing to offenders joint and several responsibility for the results of criminal activity in which they participate.¹¹⁰ This approach is moderated in two ways. First, an offender is ordinarily responsible for *all* acts that she commits or aids; for conspiratorial involvement, however, responsibility

¹⁰⁸ *But see* John C. Coffee, Jr., *Causation By Presumption? Why the Supreme Court Should Reject Phantom Losses and Reverse Broudo*, 60 BUS. LAW. 533, 541 (2005) (noting that legally material facts do not necessarily move the market).

¹⁰⁹ *See* James C. Spindler, *Why Shareholders Want Their CEOs to Lie More After Dura Pharmaceuticals*, 95 GEO. L.J. (forthcoming 2007).

¹¹⁰ *See* U.S. SENTENCING GUIDELINES MANUAL § 1B1.3.

is ascribed only for “*reasonably foreseeable* acts and omissions of others in furtherance of a jointly undertaken criminal activity.”¹¹¹ The fraud guideline also contains its own foreseeability limitation on the calculation of loss.¹¹² Second, an offender is eligible for a four-point reduction in offense level if she “was a minimal participant” or a two-point reduction if she “was a minor participant.”¹¹³ Thus there may be cases in which an offender with a small role in a large conspiracy will end up with a lower loss figure due to foreseeability restrictions. In any event, all offenders are theoretically eligible for a role reduction without regard to calculation of the loss figure. Keeping in mind that the objective is relative measurement of cases, contrasted for example with calculation of precise damages a given violator should pay, these existing adjustments are sufficient to account for role differences.

IV. CALIBRATING THE SCALE

Alas, our analysis of how to measure the seriousness of a case of financial reporting fraud is academic at the moment. Equity is an important goal but equally irrational sentences are still irrational. The Guidelines as presently ordered push almost every large case of public company reporting fraud off the top of the charts, meaning that most methodologies for calculating loss end up with the same result in terms of imprisonment.¹¹⁴ In addition, the Guidelines double- and triple-count other factors beside loss, to the point where application of the Guidelines can become absurd, yielding results so astronomical that no one rationally could have intended them. Only a Congress that had entirely abandoned proportionality as an objective in sentencing could embrace the results that sometimes follow under present law; at least at a general level, this Congress has maintained fealty to proportionality as a sentencing goal.¹¹⁵ Even the severe federal narcotics Guidelines, except for major participants in cases involving extremely large quantities of drugs, are not as severe as the current Guidelines for the

¹¹¹ *Id.* § 1B1.3(a)(1)(B) (emphasis added).

¹¹² *Id.* § 2B1.1 cmt. n.3(A)(iv).

¹¹³ *Id.* § 3B1.2.

¹¹⁴ *See* United States v. Ebbers, 458 F.3d 110, 129 (2d Cir. 2006) (“[Defendant’s] arguments with regard to the loss calculation encounter a hard fact. A 26-level loss calculation has a \$100 million threshold, which is easily surpassed under any calculation.”); United States v. Olis, 450 F.3d 583, 587 (5th Cir. 2006) (denying bail for defendant scheduled to be resentenced after appeals court reversed district court for insufficiently rigorous loss calculation, in part on ground that “even were [the defendant] held responsible for only one percent of [the original loss] amount (\$1 million), [he] would still face an imprisonment range of 97 to 121 months”).

¹¹⁵ *See* 18 U.S.C. § 3553 (2006) (requiring federal courts to impose sentences “sufficient, but not greater than necessary” to accomplish deterrence, reflect the seriousness of the offense, and avoid unwarranted disparities among defendants).

largest accounting frauds.¹¹⁶

To see why recalibration is needed to achieve rationality in sentencing for financial reporting fraud, let's work our Acme example through the current Guidelines. Because the offense of conviction is securities fraud, the base offense level is 7.¹¹⁷ Next we add points for dollar loss. Assume we apply the preferred (and relatively conservative) methodology described above, deriving a loss of eighty million dollars. We would add twenty-four points, reaching level 31.¹¹⁸ (If we instead used the market capitalization approach, with the loss being some \$800 million, we would add thirty points, reaching level 37 at this stage.)¹¹⁹ But we are not done. Because Acme is a large public company and many shareholders were harmed, we would add another six points, reaching level 37.¹²⁰ Because accounting fraud inevitably involves "sophisticated means," we would add another two points, reaching level 39.¹²¹ Because COO, CFO and CAO were officers of a public company, we would add another four levels, reaching level 43.¹²² Finally, CAO would probably merit a further increase of two levels for being "an organizer, leader, manager, or supervisor" in the crime, reaching level 45.¹²³

At level 43, the Guidelines provide for a sentence of life imprisonment without parole as the *only available option*.¹²⁴ Even a relatively conservative estimate of loss can send the offense level above the Guidelines' top level of 43, meaning that reductions for pleading guilty or for not qualifying for some of the enhancements described above may have no material effect on the bottom-line result under the Guidelines.¹²⁵ In addition, we did not consider another enhancement often applicable in large cases of accounting fraud: If the offense "substantially endangered the solvency or financial security" of a

¹¹⁶ See Bowman, III, *supra* note 35, at 334 ("No other class of federal crime produces offense levels [as high as for large corporate frauds]."). For example, the current narcotics Guidelines provide that no defendant who receives a downward adjustment for mitigating role in the offense may have a base offense level of more than 30, even though drug quantity ordinarily can drive the base offense level as high as 38. See U.S. SENTENCING GUIDELINES MANUAL § 2D1.1(a)(3). The fraud Guidelines contain no equivalent ceiling for minor offense participants.

¹¹⁷ U.S. SENTENCING GUIDELINES MANUAL § 2B1.1(a)(1).

¹¹⁸ *Id.* § 2B1.1(b)(1)(M).

¹¹⁹ *Id.* § 2B1.1(b)(1)(P).

¹²⁰ *Id.* § 2B1.1(b)(2)(C) (adding six levels for offense involving 250 or more victims).

¹²¹ *Id.* § 2B1.1(b)(9).

¹²² *Id.* § 2B1.1(b)(15)(A).

¹²³ *Id.* § 3B1.1(c). If COO, CFO and CAO enlisted other employees in the accounting fraud, this increase could go up to four levels. *Id.* § 3B1.1(a).

¹²⁴ *Id.* Sentencing Table.

¹²⁵ See, e.g., *United States v. Adelson*, 441 F. Supp. 2d 506, 509 (S.D.N.Y. 2006) (government argued that correct application of Guidelines resulted in total offense level of 55; court remarked, "55 is a level normally only seen in cases involving major international narcotics traffickers, Mafia dons, and the like").

publicly traded company (as would be true in a bankruptcy or near bankruptcy), yet another four levels are added.¹²⁶ The Guidelines provide that any offense level above 43 is to be treated as level 43, requiring life without parole.¹²⁷ (Apparently the drafters of the Sentencing Table did not talk to the drafters of the fraud Guideline: An application note to the Sentencing Table acknowledges that an offense level over 43 “may result” but says this will occur only in “rare cases.”)¹²⁸

One might think these nonsensical results are a product of overreaction to Enron and other major corporate scandals of 2001 and 2002. While it is true that the Sarbanes-Oxley legislation¹²⁹ caused increases in the penalties for white collar crime, Sarbanes-Oxley turns out to be only part of the story. The bigger problem is that no lawmaker, in Congress or at the Sentencing Commission, has seriously considered the problem of how the Guidelines applicable to all fraud cases work in the special case of financial reporting fraud in public companies.¹³⁰ In 2001, the Sentencing Commission adopted a major revision of the Guidelines governing economic crimes, after a process that a leading expert on the Guidelines has praised as “long, careful, open, and consultative” and “guidelines lawmaking as it was intended to work.”¹³¹ Yet even the 2001 Guidelines could result in strikingly long terms of imprisonment for financial reporting fraud.

Consider our Acme example under the 2001 Guidelines. We would have started at a base offense level of 6.¹³² With our conservative loss methodology resulting in a figure of eighty million dollars, we would have added twenty-four levels, reaching level 30.¹³³ We then would have added four levels for the number of victims involved in the offense, reaching level 34.¹³⁴ We would have added two more levels because the fraud involved “sophisticated means,” reaching level 36.¹³⁵ The sentencing range for a first-time offender such as CFO

¹²⁶ U.S. SENTENCING GUIDELINES MANUAL § 2B1.1(b)(13)(B).

¹²⁷ *Id.* Sentencing Table, cmt. n.2.

¹²⁸ *Id.*

¹²⁹ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745.

¹³⁰ See Bowman, III, *supra* note 22, at 527 (“When the drafters of the Guidelines created a sentencing scheme for economic crime which made measurement of harm the predominant sentencing factor, but failed to define the required causal relation between the criminal conduct and the harm to be measured, the current thicket of uncertainty became not only predictable, but inevitable.”).

¹³¹ Frank O. Bowman, III, *Pour encourager les autres? The Curious History and Distressing Implications of the Criminal Provisions of the Sarbanes-Oxley Act and the Sentencing Guidelines Amendments that Followed*, 1 OHIO ST. J. CRIM. L. 373, 390 (2004).

¹³² U.S. SENTENCING GUIDELINES MANUAL § 2B1.1(a) (2001).

¹³³ *Id.* § 2B1.1(b)(1)(M).

¹³⁴ *Id.* § 2B1.1(b)(2)(B).

¹³⁵ *Id.* § 2B1.1(b)(9).

at level 36 was 188 to 235 months (15.6 to 19.5 years).¹³⁶ For CAO, who would probably have merited a further increase of two levels for being “an organizer, leader, manager, or supervisor” in the crime, the sentencing range would have been 235 to 293 months (19.5 to 24.4 years), at level 38.¹³⁷

In a more serious case than our Acme example, the 2001 Guidelines (like the post-Sarbanes-Oxley Guidelines) could result in a sentence of *life imprisonment without parole*. That severe result was apparently called for under the Guidelines as calculated by the United States Probation Department at the sentencing of former Worldcom CEO Bernard Ebbers, which involved pre-Sarbanes-Oxley offenses.¹³⁸ Indeed, the case that has become most emblematic of harshness in current white collar sentencing, *United States v. Olis*, involved a sentence of 24.3 years imposed under the 2001 Guidelines; Sarbanes-Oxley applied to neither the criminal liability nor the sentence in *Olis*.¹³⁹

Sarbanes-Oxley made matters worse by causing a further, unnecessary ratcheting-up of the Guidelines in fraud cases through a process that involved virtually no consideration of the wisdom and necessity of further increases.¹⁴⁰ Indeed, until the eleventh hour, the Department of Justice did not take the position before Congress that further increases in the Guidelines governing white collar crime were a necessary or appropriate response to the spate of corporate scandals.¹⁴¹ But the more fundamental problem is that no lawmaker appears to have done any real thinking about how to punish financial reporting fraud—at *any* stage, notwithstanding that we have now spent over two decades on the project of rationalizing criminal sentencing and that Congress passed an entire package of legislation in direct response to a spate of *accounting fraud*.

Sentencing judges, of course, are the recipients of this problem. They must find an appropriate way to punish defendants in cases of financial reporting fraud in the absence of clear, rational guidance. The draconian effect of the Guidelines leads to one of two results, neither satisfactory and both undermining the objectives of proportionality and equality in sentencing. Some judges are simply applying the

¹³⁶ *Id.* Sentencing Table.

¹³⁷ *Id.* § 3B1.1(c); Sentencing Table.

¹³⁸ See *United States v. Ebbers*, 458 F.3d 110, 126-30 (2d Cir. 2006).

¹³⁹ *United States v. Olis*, 429 F.3d 540, 544 (5th Cir. 2005).

¹⁴⁰ Frank Bowman has exhaustively recounted this process. Bowman, III, *supra* note 131, at 392-419. There is no need to repeat the clear and dispiriting story he tells. One aspect is worth emphasis for purposes of my discussion: Most of what Sarbanes-Oxley did on the criminal side involved increasing the *statutory maxima* for many white-collar offenses, a measure that was almost exclusively symbolic and immaterial to sentencing given that most cases of securities and wire fraud can and do lead to many charged counts. See *id.* at 399-405.

¹⁴¹ See *id.* at 395.

Guidelines, as written and in full force, resulting in sentences of nearly life imprisonment for offenses that no one can have intended would (or honestly believe should) result in such punishments.¹⁴² (No judge, to my knowledge, has bit the bullet and imposed a sentence of life imprisonment without parole on a white collar offender, but perhaps this is only a matter of time.)¹⁴³ Other judges are abandoning the Guidelines entirely in such cases, on the basis of their facial irrationality, and sentencing offenders to greatly reduced terms of imprisonment that comport with the judge's own conception of just punishment for corporate fraud.¹⁴⁴ The problem of disparity in fraud sentencing is, at present, double-faceted: We lack consensus on methodology for calculating loss and the current Guidelines are so unreasonable that, even if courts were applying a consistent loss methodology, many judges would still be defecting from the system to impose non-Guidelines sentences.

Four conclusions seem obvious: (1) loss to investors is the proper common denominator to measure cases of financial statement fraud; (2) an appropriate methodology for measuring loss must balance the need for clarity, efficiency, and uniformity in sentencing across cases with the need for ascribing responsibility only for the actual results of offenders' criminal conduct; (3) any "loss table" that arrays the cases in terms of seriousness, and primarily drives the severity of terms of

¹⁴² See, e.g., *Ebbers*, 458 F.3d at 129-30 (affirming sentence of twenty-five years' imprisonment as "harsh but not unreasonable" in view of "Congress' policy decisions on sentences for fraud"; stating, "[I]t may well be that all but the most trivial frauds in publicly traded companies may trigger sentences amounting to life imprisonment However, the Guidelines reflect Congress' judgment as to the appropriate national policy for such crimes."). In *Ebbers*, the district court actually demonstrated some *leniency* by imposing a sentence of twenty-five years even though the court calculated the Guidelines at thirty years to life and the Probation Department calculated them at life. See also *Olis*, 429 F.3d at 541-42 (district court sentenced "Senior Director of Tax Planning" for a Houston energy company to 24.3 years in prison for single fraudulent transaction relating to financial reporting; appeals court reversed on grounds of improper methodology for calculating loss, not harshness of sentence).

¹⁴³ I have found one case in which the government actually argued (dutifully, but without much conviction) for a sentence of life without parole. See *United States v. Adelson*, 441 F. Supp. 2d 506, 507 (S.D.N.Y. 2006). In discussion about the death penalty, one often hears the point that one can posit at least one case in which most would agree that a death sentence is just punishment (unimpeachable forensic proof of a mass murder of hundreds of random victims including children, and so on). I have not seen anyone posit the facts of a white collar crime that would cause most people to conclude that a sentence of life imprisonment without parole would be just. I, at least, cannot imagine such a case. *Id.* at 511 ("[e]ven the government blinked at [the] barbarity" of a sentence of eighty-five years' imprisonment for a forty-year-old convicted executive).

¹⁴⁴ See *id.* at 515 (court imposed sentence of forty-two months when Guidelines provided for life sentence because "the guidelines have so run amok that they are patently absurd on their face"); Transcript of Sentencing, *United States v. Daniel Bayly*, No. H-CR-03-963 (S.D. Tex. Apr. 21, 2005) (on file with author) (sentencing defendant to thirty months' imprisonment where Guidelines provided for sentence over ten years because "[f]or a person who has been a leader in the investment banking world to go to prison at all is a deterrent effect upon others").

imprisonment, must be calibrated rationally and proportionally; and (4) additional factors may appropriately mitigate or aggravate sentences but they should not undermine proportionality and rationality by skewing most or all sentences to the top of the punishment scale, or by double-counting factors such as the number of investors harmed.¹⁴⁵

These conclusions lead me to the following reform recommendations:

- i. Adopt a separate guideline governing financial reporting fraud. It is a mistake to equate the loss involved in an embezzlement, a theft, or a scam with the loss that results when a public company reveals financial reporting fraud. Because the loss in financial reporting cases is less direct, more diffused, more complicated as a matter of causation and often of massively larger scale, such cases should not be measured on the same scale as routine fraud cases.¹⁴⁶
- ii. In that separate guideline, direct courts to follow a single, workable, and realistic methodology for calculating loss as described in Part III.B. This methodology should rely on the approach dictated by the PSLRA, modified by permitting courts to adjust the relevant share price but only with reference to objective, quantifiable market data such as the company's own stock history or relevant indices such as the S&P 500.
- iii. In that separate guideline, set the base offense level higher than at present (perhaps at level 12), because any case of public company fraud on shareholders is more serious than the lowest-level cases of ordinary theft and fraud. Then set the loss table significantly lower than at present. Twelve of the sixteen levels on the current loss table are set at amounts of fifty million dollars or less, plainly rendering

¹⁴⁵ I do not mean to suggest that there is not room for reforms in other areas of the Guidelines. However, the problems with the Guidelines in major fraud cases are so glaring that they ought to provide among the very least controversial (and therefore realistic) places to seek improvement.

¹⁴⁶ See *Ebbers*, 458 F.3d at 128 (even under defense expert's "event study" calculation, which attributed only thirty-five percent of stock decline to accounting fraud, loss amount still over one billion dollars); *Adelson*, 441 F. Supp. 2d at 509 ("Since successful public companies typically issue millions of publicly traded shares . . . the precipitous decline in stock price that typically accompanies a revelation of fraud generates a multiplier effect that may lead to guideline offense levels that are, quite literally, off the chart."). In addition, there is no need to saddle the project of reforming the Guidelines as they apply to financial statement fraud with the burden of persuading people to revise the entire framework governing economic crimes. A separate guideline for accounting fraud cases is also natural given that existing law includes a separate guideline for insider trading. See U.S. SENTENCING GUIDELINES MANUAL § 2B1.4.

the general loss table ill-suited to financial reporting fraud involving large public companies. A suitable loss table for financial reporting fraud might be set approximately as follows:

LOSS	LEVEL INCREASE
≤ \$500,000	0
> \$1,000,000	4
> \$4,000,000	6
> \$10,000,000	8
> \$20,000,000	10
> \$50,000,000	12
> \$100,000,000	14
> \$500,000,000	16
> \$1,000,000,000	18

Calibrating the loss table would be the most contestable step in reforming this aspect of sentencing. I do not mean to engage that debate fully or defend any particular result. Many permutations of a new guideline for financial reporting fraud would be possible and more rational than the current scheme.¹⁴⁷ My point is simply that some significant revisions, both downward and in reduced double-counting, are necessary to get the Guidelines back on the rails. At present, virtually every case that comes along involves nonsensical results such as thirty years of imprisonment or life without parole.

- iv. In the new guideline, include existing enhancements for endangering the solvency or security of the company and for leadership role in the offense, as well as existing reductions for minor role in the offense.¹⁴⁸ Abandon

¹⁴⁷ Without fully opening the debate on severity, it is fair to say that the prevailing view, at least among academics, is that deterrent and retributive aims can best be satisfied with white collar crime by sentences that are relatively short but that include imprisonment and the high probability of its imposition. *See, e.g.,* Bibas, *supra* note 35, at 739-40; *see also* Stephen Breyer, *The Federal Sentencing Guidelines and the Key Compromises Upon Which They Rest*, 17 HOFSTRA L. REV. 1, 20 (1988) (“short but certain terms of confinement for many white-collar offenders” was objective of Guidelines project at inception). For an alternative proposed loss table (with only six levels ranging from \$10,000 to \$100 million), see Bowman, III, *supra* note 35, at 330.

¹⁴⁸ *See Adelson*, 441 F. Supp. 2d at 508-09 (noting draconian effect of applying entire loss amount in accounting fraud to defendant who participated in scheme only in late stages); *see also* United States v. Brown, 459 F.3d 509, 531 (5th Cir. 2006) (reversing convictions of investment bankers for aiding accounting fraud at Enron on basis of participation in one relatively small transaction that enabled Enron to meet earnings targets in a single quarter).

enhancements that either apply to all cases of financial reporting fraud or would double-count because they are captured by other enhancements or by the loss calculation: Use of “sophisticated means”; large number of victims; and the defendant’s status as an officer or director of a public company.¹⁴⁹

V. AVENUES FOR REFORM

Three institutions have the power to remedy the law’s deficiencies concerning sentencing for financial reporting fraud: Congress, the United States Sentencing Commission and the federal courts.¹⁵⁰ All three can and should act.

Congress has the most power and its involvement would address the problem most directly. The Sentencing Commission and Guidelines are creatures of legislative delegation. Congress retains the authority, within constitutional constraints, to reshape them at virtually any level of generality. Congress could enact a new guideline governing financial reporting fraud or, consistent with past practice, direct the Commission to develop a new guideline and provide parameters or policy objectives to steer that project. About the only relevant thing Congress could not do is generate a judge-applied guideline that would be mandatory (because that would be unconstitutional).¹⁵¹

Of course, anyone with passing familiarity with the history of federal sentencing law knows that the preceding paragraph is pie in the sky. Congress rarely gets involved in sentencing law at the level of specific Guidelines provisions; it generally does so only in connection with “tough on crime” focal points, like the cocaine-to-crack weight

¹⁴⁹ See Bowman, III, *supra* note 35, at 333 (“what the Guidelines have done over time is to tease out many of the factors for which loss was already a rough proxy and give them independent weight in the offense level calculus.”). For those interested in the bottom line, following this reform example would have led to approximately the following sentences: For COO, CFO and CAO in our Acme example, four and a half and five and a half years’ imprisonment respectively; for James Olis (the Dynegy official), perhaps five years’ imprisonment; and for former Worldcom CEO Bernard Ebbers and former Enron CEO Jeffrey Skilling, perhaps fifteen years’ imprisonment.

¹⁵⁰ I exclude the United States Department of Justice because, while it certainly has the power to direct its prosecutors to recommend non-Guidelines sentences (even pursuant to an express policy that might adopt an approach like the one I recommend), that is not the way sentencing reform is meant to work. The Department is supposed to advocate for enforcement of existing law, while lobbying for changes in that law when needed. The Department has a remarkably successful record when seeking changes in sentencing law, before both Congress and the Sentencing Commission. Its proper role here would be to participate in revising the law by expressing its support for needed changes to Congress and the Commission.

¹⁵¹ See *United States v. Booker*, 543 U.S. 220 (2005).

ratio under the narcotics guidelines.¹⁵² Congress has never intervened in the Guidelines process in order to *lessen* the severity of sentences.

Fortunately, the Sentencing Commission has power to act in response to the problem of punishment for financial fraud. Contrary to what many may believe (including apparently at least one federal appeals court),¹⁵³ the current Guidelines governing financial reporting fraud are not the result of any congressional mandate, including Sarbanes-Oxley. Much of the unreasonableness of the Guidelines results from the failure to appreciate their application to large cases of accounting fraud during the process of revision in 2001, which was a reform effort initiated by the Commission not Congress.¹⁵⁴ To the extent Sarbanes-Oxley led to further severity, it was not inevitable: The Act's directives to the Commission dictate review and revision, not any particular result.¹⁵⁵ A conclusion that special provisions are needed for cases of financial reporting fraud could hardly be deemed unreasonable given that so many cases now come out at life imprisonment, the most severe punishment short of death, and that Congress intended the majority of the Sarbanes-Oxley legislation as a response to the specific problem of financial reporting fraud.¹⁵⁶ In any event, Congress would be much less likely to question the Commission's work in this area now than it might have been during the heated period just after the collapse of Enron and Worldcom.

What if the Sentencing Commission fails to act or takes so long to act that many of the current cases of financial reporting fraud cannot

¹⁵² See NORMAN ABRAMS & SARA SUN BEALE, FEDERAL CRIMINAL LAW AND ITS ENFORCEMENT 365 (5th ed. 2005).

¹⁵³ See *United States v. Ebberts*, 458 F.3d 110 (2d Cir. 2006).

¹⁵⁴ See *Bowman, III*, *supra* note 131, at 387-91.

¹⁵⁵ Section 905 of the Act provides, in part:

[T]he Sentencing Commission shall (1) ensure that the sentencing guidelines and policy statements reflect the serious nature of the offenses and the penalties set forth in this Act, the growing incidence of serious fraud offenses which are identified above, and the need to modify the sentencing guidelines and policy statements to deter, prevent, and punish such offenses; [and] (2) consider the extent to which the guidelines and policy statements adequately address whether the guideline offense levels and enhancements for violation of the sections amended by this Act are sufficient to deter and punish such offenses, and specifically, are adequate in view of the statutory increases in penalties contained in this Act.

Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 905, 116 Stat. 745, 746 (2002). Section 1104 of the Act provides, in part:

[T]he United States Sentencing Commission is requested to . . . promptly review the sentencing guidelines applicable to securities and accounting fraud and related offenses In carrying out this section, the Sentencing Commission is requested to . . . ensure that the sentencing guidelines and policy statements reflect the serious nature of securities, pension, and accounting fraud and the need for aggressive and appropriate law enforcement action to prevent such offenses.

Id. § 1104; see also *Bowman, III*, *supra* note 131, at 412 (arguing that language of Sarbanes-Oxley did not require the Commission to alter the Guidelines as it did).

¹⁵⁶ See *Bowman, III*, *supra* note 131, at 413.

benefit from its efforts? Federal judges are not bound to apply the existing Guidelines given the Supreme Court's ruling that mandatory, judicially applied guidelines are unconstitutional.¹⁵⁷ Federal judges still must follow statutory directives to consult the Guidelines and consider what form and quantity of punishment are necessary to achieve objectives of retribution and deterrence.¹⁵⁸ Their sentences are still subject to appellate review for "reasonableness."¹⁵⁹ But faithful adherence to these requirements would push sentences in cases of financial reporting fraud *away* from the bottom-line results under current economic crime guidelines, not toward them.

Judicial action on this problem need not lead to haphazard sentencing, even though the courts are moving in that direction. The primary virtue of non-binding guidelines, as in the current post-*Booker* environment, is that they provide a focal point and coordination device that reduces the inequality and randomness that can result when hundreds of judges in hundreds of cases impose criminal sentences based only on their individual preferences. While not as effective as centrally promulgated guidelines, judicial opinions can also be effective coordination devices. All it would take is for a single judge to issue a persuasive opinion, setting forth a rigorous and reasonable loss-based methodology for sentencing accounting fraud defendants, for another judge to follow the approach, and so on. While judges might vary in their views on how harshly to punish white-collar crime, few if any can believe that irrationality, chance and lack of proportionality are desirable objectives for a sentencing system. There is ample incentive and adequate means for district court judges collectively to take action.

CONCLUSION

My target has been narrow, but it could hardly be more pressing. No topic in the torrent of public discussion that has followed from the collapse of the Enron Corporation, and other recent market developments, is more important than the decision whether to revoke the liberty of a former corporate executive for years, decades or even life. It is inexcusable that there should be bald and easily remedied deficiencies in the law governing this decision and that those deficiencies should persist even as case after significant case comes before the courts for sentencing. Congress, the Sentencing Commission and the courts should get on with the business of repair by adopting and

¹⁵⁷ *United States v. Booker*, 543 U.S. 220, 243-44 (2005).

¹⁵⁸ *See* 18 U.S.C. § 3553 (2006).

¹⁵⁹ *See Booker*, 543 U.S. at 260-64.

applying a systematic methodology for calculating loss and punishment in cases of financial reporting fraud that advances objectives of proportionality and rationality.