United States Sentencing Commission

LOSS ISSUES

May 26, 2000

official position of the Commission, and should not be considered definitive, and is not binding upon the Commission, the Court, or the parties in any case.

LOSS ISSUES

INTRODUCTION

This memorandum discusses issues raised about the definition of loss in the case law. It is not intended as a comprehensive compilation of all case law addressing these issues.

The following issue areas are discussed in this memorandum:

A. Actual Loss

1. Causation

Current rule: There is no explicit standard of causation in the definition of loss. The relevant conduct guideline provides that relevant conduct includes "all harm that resulted from the acts and omissions specified in subsections (1)(A) and (1)(B) above that were part of the same course of conduct or common scheme or plan as the offense of conviction." §1B1.3(a)(3).

Issue: Should the Commission adopt an explicit causation standard, address multiple causation situations, or add commentary language allowing departures when substantial unforeseen losses occur?

Impetus: The guidelines have three distinct and arguably inconsistent standards for loss causation. First, the relevant conduct rule in §1B1.3 holds a defendant responsible for all losses, foreseen or unforeseen, that result from the defendant's actions or the foreseeable actions of his or her associates. *See, e.g., United States v. Sarno*, 73 F.3d 1470, 1500 (9th Cir. 1995) ("A sentence calculated pursuant to the loss tables . . . is properly based on actual loss notwithstanding the fact that this loss may be greater than the intended, expected, or foreseeable."), *cert. denied*, 518 U.S. 1020 (1996); *United States v. Catalfo*, 64 F.3d 1070, 1082-83 (7th Cir. 1995) (holding defendant accountable for loss caused by acts of co-conspirator), *cert. denied*, 517 U.S. 1192 (1996). Second, §2F1.1's commentary limits the loss amount to "the value of the money, property, or services unlawfully taken." *See United States v. Marlatt*, 24 F.3d 1005, 1007-08 (7th Cir. 1994) (refusing to count foreseeable losses in loss figure because they did not represent "the thing actually taken"); *see also United States v. Wilson*, 993 F.2d 214, 217 (11th Cir. 1993)("The phrase 'property taken, damaged or destroyed' [from §2B1.1] does not allow for inclusion of incidental or consequential injury. . . ."). Third, the commentary's explicit inclusion of "consequential damages" in the loss figure for contract procurement and product substitution cases implies that only "non-consequential" or "direct" damages are included in other cases. *See, e.g., United States v. Thomas*, 62 F.3d 1332, 1346-47 (11th Cir. 1995), *cert. denied*, 516 U.S. 1166 (1996).

Case law: Although there is no explicit requirement of causation in the definition of "loss," the relevant conduct guideline provides that relevant conduct includes "all harm that resulted from the acts and omissions specified in subsections (a)(1) and (a)(2) above, and all harm that was the object of such acts and omissions." §1B1.3(a)(3). This requirement that relevant harm "result from" the defendant's criminal conduct strongly implies that the defendant's offense behavior must be at least a cause of all harm that becomes part of the loss calculation. The question that emerges is whether the defendant should be held accountable where events beyond his control greatly magnify the harm caused.

An illustration of this question is provided by *United States v. Neadle*, 72 F.3d 1104 (3d Cir.), *op. amended by* 79 F.3d 14, *cert. denied*, 519 U.S. 895 (1996). Neadle was convicted of one count of mail fraud in connection with his misrepresentation that he had the necessary assets, $700,000 in unencumbered initial working capital, to justify the issuance to him of a license to write property and casualty insurance in the Virgin Islands. While the $700,000 asset which Neadle offered for this purpose was encumbered, he subsequently purchased $4,000,000 in reinsurance to provide some protection to his clients. Insurance regulations in the Virgin Islands did not require the purchase of any reinsurance.

About 20 months after Neadle's company received its insurance license Hurricane Hugo devastated the Virgin Islands. Neadle's company was able to pay more than $4,000,000 to its clients who sustained damage from Hurricane Hugo. However, because of the scope of the damage caused by Hugo, Neadle's assets were exhausted before claims in excess of an additional $20,000,000 could be paid.

The majority affirmed the district court's conclusion that this $20,000,000 shortfall was caused by Needle's criminal conduct and was the proper measure of loss on which to base Neadle's offense level. The dissent reasoned that Neadle's criminal conduct did not cause these catastrophic losses and, as such, Neadle should not be held responsible for the entire amount of the shortfall. The dissent did not see Neadle's conduct as a "cause in fact" of the shortfall and would have held Neadle responsible only for the $700,000 which he had misrepresented as unencumbered assets.[1]

In grappling with the question of how much restitution the defendant should pay in a bank bribery case, the First Circuit has articulated a "modified but for" standard of causation. *United States v. Vaknin*, 112 F.3d 579 (1st Cir. 1997). In that case the First Circuit declined to hold the defendant accountable, for restitution purposes, for amounts which were attributable more to a drop in the value of the collateral which secured the fraudulently obtained loans than to the defendant's conduct. The First Circuit stated:

> ... the government must show not only that a particular loss would not have occurred but for the conduct underlying the offense of conviction, but also that the causal nexus between the conduct and the loss is not too attenuated (factually or temporally). The watchword is reasonableness.

Id. at 590.

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[1]Even if the fraud guideline contained a "cause in fact" requirement for any damages to be included as loss, the result in Neadle would have been the same. It is unclear whether the majority would have seen $20,000,000 as the loss here if a more stringent, "proximate cause" standard existed.

Thus, at least for restitution calculations, the First Circuit requires not only that the defendant's conduct be a cause of the harm for which restitution is sought, but also that the defendant's conduct be reasonably closely linked to any damages which result.

2. Consequential damages

Current rule: Neither §2B1.1 or §2F1.1 is explicit about inclusion of consequential damages. In §2B1.1 "reasonable replacement cost to the victim" is one way loss may be measured "[w]here the market value is difficult to ascertain or inadequate to measure harm to the victim." Although §2F1.1 does not explicitly provide a rule on the general use of consequential damages, it is fair to infer that they generally are not to be included, because there is a specific rule allowing their use in procurement fraud and product substitution cases.

Issue: Should the Commission amend the commentary to explicitly include or exclude consequential damages in determining loss?

Impetus: Given the effort to make the definition of loss more clear, it seems appropriate to consider providing explicitly how consequential damages should be handled in the determination of loss.

Case law: Section 2F1.1, n. 8(c) states: ". . . loss in a procurement fraud or product substitution case includes not only direct damages, but also consequential damages that were reasonably foreseeable." Thus, by clear implication, the Commission has ruled out consequential damages as an element of loss in other types of frauds. Nevertheless, by taking an expansive view of the definition of "loss" (*i.e.* "the value of the property taken, damaged or destroyed") some courts have arguably included consequential damages within loss in cases other than procurement frauds or product substitution frauds. Examples of such holdings are: *United States v. Gottfried*, 58 F. 3d 648 (D.C. Cir. 1995) and *United States v. Berkowitz*, 927 F. 2d 1376 (7th Cir.); *cert. denied*, 502 U.S. 845 (1991).

In *Gottfried*, 58 F. 3d at 649-50, an attorney for the Board of Veterans Appeals wrongfully removed documents from files of cases he was working on and then recommended remand to the various hearing officers on the basis of "incomplete files." The object of this charade was to avoid doing substantive work on the appeals. The defendant was convicted of destruction of government documents in violation of 18 U.S.C. § 2071, an offense that is sentenced under §2B1.3. Despite the fact that the documents he destroyed had no inherent value, the District of Columbia Circuit upheld the inclusion, in the loss calculation, of the subsequent cost of processing the 32 files with which Gottfried tampered. This sum included the pro rata overhead expenses, such as utilities and cost of paying support staff, of running the Board during the time these 32 cases were prepared and heard. One could arguably view these sums as consequential damages that would not properly be included as loss in this non-procurement, non-product substitution case.

The Court refused to limit loss to the fair market value, in this case, the nominal value of the paper destroyed, reasoning that such a result would make "no sense," where "the purpose of the exercise is to measure the economic harm Gottfried caused." *Id.* at 651, citing §2B1.1, comment. (backg'd), that provides that "'Where the market value is difficult to ascertain or inadequate to measure harm to the victim, the court may measure loss in some other way . . ..' USSG §2B1.1, comment. (n.2)."

The Court even upheld the inclusion in loss of the Board's pro rata overhead expenses that would have been incurred even if the criminal offense had not been committed, concluding that including such expenses "in the amount of the Board's loss, or 'fee,' for reprocessing the 32 appeals merely attributed to Gottfried the cost of undoing the damage he had done." *Id.* Regarding decisions that hold that incidental or consequential damages may not be included in the loss calculation, the District of Columbia Circuit said those cases stand for the proposition that only "direct" losses count. *Id.* at 652.

Similarly, in *Berkowitz*, the Seventh Circuit upheld the inclusion of the cost of reorganizing a file, re-interviewing witnesses and recreating documents where a taxpayer trashed the government's investigative file regarding his alleged tax fraud, and was convicted of obstruction of justice (18 U.S.C. § 1503) and stealing government property (18 U.S.C. § 641). The amounts included in loss did not represent the value of properly assessed taxes that went unpaid, but instead represented the cost to the government of determining the size of the tax shortfall. The Seventh Circuit concluded that the value of the documents was their "replacement cost." *Berkowitz*, 927 F. 2d at 1391. However, in that case the appellant did not make an argument that the disputed costs should be excluded because they represented consequential damages; rather, he argued that the government did not introduce sufficient evidence to support the estimated cost of replacing the documents.

In *United States v. Green*, 114 F.3d 613, 617 (7th Cir. 1997), the defendant was a nurse who was responsible for creating fraudulent bills in conjunction with a scam where automobile accidents were staged and fraudulent medical bills were submitted to insurance companies for payment. While the Court held that only direct, and not consequential losses, are to be counted as damages, they found loss to include not only the amount of the medical bills submitted from the Lakeside Medical Clinic, where the defendant was employed, but amounts above that figure that the various insurance companies who were the targets of the scheme paid out. The larger amount included payments of property damages and loss of wages. The Court held that the full amount of insurance company payments were direct damages caused by the fraud, and thus "loss" for purposes of §2F1.1. The Court did not accept the defendant's argument that they were consequential and not direct losses.

In *United States v. Ortland*, 109 F.3d 539, 547 (9th Cir.), *cert. denied*, 522 U.S. 851 (1997), the defendant was convicted of defrauding investors of the Three El Sobrante, a partnership he and his then-wife had created to develop residential real estate. As part of the fraud, money was diverted for the personal use of the defendant. In determining the amount of loss, the Court took the amount invested and subtracted the amount of money returned to investors by the receiver appointed to manage Three El Sobrante. The Court included the receiver's fees of $92,000 and the attorney's fees of $59,000 in calculating loss. The Court found that these fees were necessary to reduce the loss to investors, and thus were not consequential damages, but part of the direct losses to investors.

In *United States v. Izydore,* 167 F.3d 213 (5th Cir. 1999), the Court affirmed the Sentencing Court's refusal to include bankruptcy trustee fees in computing loss, when the fees were incurred after the defendant's unlawful conduct had ended. Although the fees met a "but for" causation standard, the Court wrote that the appropriate measure of loss at §2F1.1(b)(1) is the value of the thing taken, and that "we have found, as other Courts' have, that consequential losses typically are not counted when computing loss...." *Id*. at 223. The Court concluded that the trustee fees were consequential, and should not be utilized for computing loss.

3. <u>Interest</u>

Current rule: Section 2F1.1, n. 8 provides that loss "does not, for example, include interest the victim could have earned on such funds had the offense not occurred." In a fraudulent loan case "the loss is the amount of the loan not repaid at the time the offense is discovered, reduced by the amount the lending institution has recovered (or can expect to recover) from any assets pledged to secure the loan." §2F1.1, comment. (n. 8(b)).

Issue: Should the Commission clarify the rule regarding when interest is included in loss?

Impetus: Although the Commission included language in its definition of loss that excludes interest the victim could have earned, an apparent split in the circuits has developed about whether interest the defendant agreed to pay (*e.g.,* on a fraudulently procured loan) should be included in loss.

If interest the defendant agreed to pay plays no part in the determination of loss, the defendant who makes some payments may face the same penalty as a similar defendant who makes none, because many loans are structured so that a large percentage of the early payments are allocated to interest. For example, the defendant who makes early payments in a loan application case may face a principal balance upon discovery of the offense that is only slightly reduced by the payments made. Should that defendant face a loss amount that is virtually identical to that faced by another defendant who made no payments?

Case law: Although the Commission has promulgated commentary (see "Current rule" above), that can plausibly be read to indicate the Commission's disapproval of including interest in any form as loss, most circuits that have addressed whether "bargained for" interest should be included in the calculation of loss have concluded that it should on the theory that the Commission intended to exclude only opportunity cost interest. Compare *United States v. Gilberg*, 75 F.3d 15, 18-19 (1st Cir. 1996) (including in loss interest on fraudulently procured mortgage loan); *United States v. Goodchild*, 25 F.3d 55, 65-66 (1st Cir. 1994) (holding accrued finance charges on credit cards are not "opportunity costs," and may be included in amount of loss); *United States v. Henderson*, 19 F.3d 917, 928-29 (5th Cir.) ("Interest should be included if, as here, the victim had a reasonable expectation of receiving interest from the transaction."), *cert. denied*, 513 U.S. 877 (1994); with *United States v. Guthrie*, 144 F.3d 1006 (6th Cir. 1998)(where defendant concealed assets in a bankruptcy proceeding, Court's determination that loss to creditors included interest was erroneous); *United States v. Lowder*, 5 F.3d 467 (10th Cir. 1993); *United States v. Parsons*, 109 F.3d 1002 (4th Cir. 1997)(loss calculation for postal employee who submitted fraudulent reimbursement requests for travel expenses did not include potential interest on improperly taken funds); *United States v. Hoyle*, 33 F.3d 415, 419 (4th Cir. 1994) ("[I]nterest shall not be included to determine loss for sentencing purposes."), *cert. denied*, 513 U.S. 1133 (1995).

In *United States v. Hoyle*, 33 F.3d 415 (4th Cir. 1994), *cert. denied*, 513 U.S. 1133 (1995), the appellants had been convicted of submitting false student loan applications in violation of 18 U.S.C. §§ 1001 and 371, resulting in the disbursement of over $19,000. The Fourth Circuit reversed the inclusion of interest in the calculation of loss, concluding that the "clear import" of the 1992 amendment to the commentary to §2F1.1 adding language excluding interest, was that "interest should not be included to determine loss for sentencing purposes." *Id*. at 419. In doing so the Fourth Circuit explicitly declined to follow the decision of the Tenth Circuit in *Lowder* that distinguished between opportunity cost interest (excluded) and interest the defendant has promised and indicated had been earned (properly included).

In *United States v. Lowder*, 5 F.3d 467 (10th Cir. 1993), the appellant was convicted of numerous offenses, including making false statements to a financial institution and mail fraud, in connection with a 1990 investment scheme in which he promised investor-victims a low-risk investment with a guaranteed 12 percent return. Rejecting the argument that interest should be excluded because it amounted to lost profit, the Tenth Circuit distinguished *United States v. Bailey*, 975 F.2d 1028 (4th Cir. 1992), where the Fourth Circuit limited loss to actual loss and refused to include projected profits. The Court said that "*Bailey* did not involve the promise to pay a specific rate of return, nor did the defendant send account summaries showing specific amounts owed." *Lowder*, 5 F.3d at 471. In support of its position the Tenth Circuit noted the rule allowing use of intended loss amounts in loss, and its interpretation of the commentary language on interest "as disallowing 'opportunity cost' interest or the time value of money stolen from victims." *Id*.

In *United States v. Henderson*, 19 F. 3d 917, 928 (5th Cir.), *cert. denied*, 513 U.S. 877 (1994), the Fifth Circuit included interest in loss, rejecting reliance on the commentary language on interest finding "that this commentary sweeps too broadly and, if applied in this case, would be inconsistent with the purposes of §2F1.1. *Stinson v. United States*, 508 U.S. 36 (1993)." The Fifth Circuit found that interest "should be included if, as here, the victim had a reasonable expectation of receiving interest from the transaction." *Henderson*, 19 F. 3d at 928.

In *United States v. Goodchild*, 25 F. 3d 55, 65-66 (1st Cir. 1994), the First Circuit invited Commission action on this issue, saying there is "a clash between the ambiguous language used in the Commentary [about interest] and the complexity of what constitutes interest and when it is an integral part of the value of the 'money, property or services unlawfully taken.'" Commentary 7. Our holding will not solve the problem; such resolution lies with the Sentencing Commission."

The First Circuit held that in a case involving fraudulent use of unauthorized credit cards, finance charges and late fees are not excluded pursuant to the commentary language on interest because they do not represent the narrow kind of "opportunity cost interest" proscribed by the rule. *Id*. at 66. In the view of the First Circuit the credit card agreement details the applicability of late fees and finance charges that are "part of the price of using credit cards" which the company "has a right to expect . . . will be paid." *Id.*

In *United States v. Porter*, 145 F.3d 897 (7th Cir. 1998), where a fraudulent investment scheme represented a specific annual rate of return on the investment, the Sentencing Court included in the loss calculation the appreciation the investments would have made had they been invested. The Circuit Court affirmed, holding that when Porter represented to his clients that they would receive an eight percent annual return on their investment, the "thing taken" became the represented value of the victim's investment, what he would have expected to receive if he had liquidated the account himself. Since the victim investor had been told that he had earned the accrued interest or appreciation, and he reasonably could have expected to receive that amount in addition to his original investment, the Court held that it was appropriately included in the loss calculation. *See also United States v. Nolan*, 136 F.3d 265, 273 (2d Cir.)(in pension plan assets embezzlement and fraudulent investment scheme, loss calculation included both principal, unpaid interest and penalties contracted for where the defendant defaulted on a fraudulently obtained promissory note), *cert. denied*, 118 S. Ct. 2307 (1998).

4. Value Received — Determination of credits to reduce loss.

Three discrete issues can be identified under this subject category: should payments made after discovery of the offense be credited; what payments and services received by victims should be credited against loss; and how should the timing of valuation of collateral be handled?

Current rule: Section 2F1.1 currently allows a defendant to receive "credits" against the loss figure in two specific types of cases, but is silent on others. In product substitution cases, the value of the fraudulently substituted product is credited against the loss amount. In loan application cases, the amount of payments made before the crime is discovered plus the value of "any assets pledged to secure the loan" are credited against the amount of the loan. *See* §2F1.1, comment. (n. 8(b), (c)). The current guidelines give no explicit guidance for cases like *Maurello* and *Reddeck* (infra), those Courts extracted a general crediting principle from application notes 8(b) and (c) to §2F1.1.

Issues: Generally, should the Commission clarify to what extent loss is a net loss concept? Should the Commission clarify the commentary to ensure that only collateral pledged and payments made *prior to* discovery are credited to reduce the loss figure? Should payments to early victims in Ponzi schemes be credited against loss? Should the valuation of pledged collateral be made at the time it is pledged, or should subsequent fluctuations in its value affect the loss calculation?

Impetus: Case law and helpline questions have shown uncertainty about these issues.

<u>Post discovery payments</u>. The current rule limits credits to loss to situations wherein pre-discovery payments are made and to the value of "any assets pledged to secure the loan." *See* §2F1.1, comment. n. 8(b). Confusion exists in the Sixth Circuit as to whether post-discovery payments in loan application cases can reduce the loss calculation in cases where the defendant is not a borrower.

In *dicta* in *United States v. Lucas*, 99 F.3d 1290, 1297 (6th Cir. 1996), a Sixth Circuit panel alluded to a supposed judicial exception to n. 8(b) that permitted "the amount of loss calculation payments that borrowers might be expected to make in the future" to be credited against the loss calculation in situations where the defendant was not among the borrowers. The *Lucas* Court cited *United States v. Chichy*, 1 F.3d 1501 (6th Cir.), *cert. denied*, 510 U.S. 1019 (1993), for the foregoing proposition. However, *Chichy* affirmed the Sentencing Court's estimate of actual loss based upon a calculation of the average amount of loss in a HUD loan approval scheme (wherein applicants who may not have been approved for loans were approved and thereafter purchased real estate) and not on post-discovery payments. *Id.* at 1509-10.

Some courts have applied credits beyond those explicitly provided for in the guidelines. Courts have raised questions about crediting things of value against loss. *E.g.,United States v. Maurello*, 76 F.3d 1304, 1311-12 (3d Cir. 1996) (calculating loss by subtracting value of satisfactory legal services from amount of fees paid to bogus lawyer); *United States v. Reddeck*, 22 F.3d 1504, 1513 (10th Cir. 1994) (reducing loss by value of education received from bogus university); *United States v. Castner,* 50 F.3d 1267, 1275-77 (4th Cir. 1995) (refusing to reduce loss by value of functional but fraudulently substituted products); *United States v. Morris*, 18 F.3d 562, 570 (8th Cir. 1994) (giving no credit for property pledged as security); *United States v. Barnes*, 125 F.3d 1287, 1291 (9th Cir. 1997)(defendant pharmacist impersonated a doctor at plasma clinics where he performed physical exams, Court remanded since it appeared victims received services bargained for–indicating to the appellate court there was no monetary loss).

For example, Courts have had difficulty with the issue of whether payments to early investors should count as a credit against the loss to later investors, such as in a Ponzi scheme. In *United States v. Mucciante*, 21 F. 3d 1228, 1237-38 (2d Cir.), *cert. denied,* 513 U.S. 949 (1994), the Second Circuit refused to reduce the loss by the amount that the defendant "repaid . . . as part of a meretricious effort to maintain [the victims'] confidences" in a non-Ponzi scheme.

In *United States v. Loayza*, 107 F.3d 257 (4th Cir. 1997), the Fourth Circuit applied reasoning similar to *Mucciante.* The Court included in the loss calculation the "interest" payments made to the early investors in a Ponzi-type scheme. The Trial Court found that the defendant never intended his victims should ultimately keep the sums as interest. It found that the defendant, without question, participated in a scheme where over $640,000 was taken from investors and about $98,000 was returned to the defrauded investors clearly for the purpose of continuing to defraud them to perpetrate the scheme. The Court also found significant the fact that the money was not returned out of any good faith change of mind or any concern about restoring something to the victims, but merely to perpetuate the scheme. Further, it held that the defendant should not be able to profit from monies that just happened to be back in the victim's hand while he was perpetuating the scheme because he never had any intent for them to keep the money. *Id*. at 265. The Circuit Court declined to follow the approach of "net loss" and held the defendants responsible for the value of all the property taken as intended loss, where as here payments were vital to the longevity of the scheme.

The Eleventh Circuit took a slightly different approach in *United States v. Orton*, 73 F.3d 331 (11th Cir. 1996), crediting only payments made to "losing investors," not payments to investors who made a profit. In *Orton* the defendant had received $525,865.66 from and returned $242,513.65 to the "investors." Twelve investors received more than they had invested; the total lost by the other investors was $391,540.01. *Id.* at 333. The Eleventh Circuit adopted what it dubbed the "loss to losing victims" method: it held the defendant accountable for "the net losses of all victims who lost all or part of the money they invested."

Id. at 334. The money that the defendant received from and returned to those investors who ended up with a net gain did not enter into the loss calculation. *See also United States v. Holiusa*, 13 F.3d 1043, 1044-45 (7th Cir. 1994)(Defendant perpetuated a Ponzi scheme by appropriating $11,625,739 from "investors" and returning approximately $8,000,000 in "interest," Court found "[t]he full amount invested was not the probable or intended loss because [the defendant] did not at any point intend to keep the entire sum" and remanded the case for resentencing); *United States v. Wolfe*, 71 F.3d 611, 618 (6th Cir. 1995)(following *Holiusa*).

Pre-discovery payments. Courts have also taken different approaches when determining whether the amount of loss should be reduced by funds returned to victims by defendants prior to discovery of the fraudulent scheme.

In *United States v. Allison*, 86 F.3d 940 (9th Cir. 1996), the Court held that where the defendant was convicted for fraudulently obtaining credit cards and using them, the payments made to the bank on the credit card accounts prior to detection should be credited to the defendant. The amount of charges made totaled over $40,000, but over $5,000 had been repaid to the bank prior to detection. The Court framed the issue as to whether, in a credit card fraud case, the amount paid by the defendant to the victim before indictment should be deducted from the amount of "loss" in calculating the sentence (clarified later in *Stoddard, supra,* to be a question of when scheme discovered, not when it was indicted). The Court held that after applying the "economic reality approach" the actual loss was the outstanding balance prior to the discovery of the offense, not the total amount charged on the four cards. *Id.* at 944.

However, in a similar type of case, the Eleventh Circuit, in *United States v. Bald*, 132 F.3d 1414 (11th Cir. 1998), affirmed the district court's finding that included in the loss calculation items purchased by the defendant who used her employer's credit cards to make unauthorized purchases in the amount of more than $500,000. Some items were returned before detection. The Court refused to deduct the amount of returned merchandise, holding that all charges made by the defendant should be included in actual loss. *Id.* at 141-17. The fact that the defendant later returned merchandise obtained by using the card was not important to the sum of unauthorized charges. The Court held that §2B1.1's definition of loss applied because although the credit cards were not stolen, misuse of a credit card entrusted to one's care is analogous to theft. *Id.* Therefore, the unauthorized use occurred at the time of the moment of purchase.

In determining whether to credit the defendant with economic benefits before detection, the issue of when detection occurs has been addressed by the Ninth Circuit in *United States v. Stoddard*, 150 F.3d 1140 (9th Cir. 1998), *cert. denied,* 119 S. Ct. 1089 (1999). In *Stoddard*, the defendant misused $30,000 of escrow funds to his advantage. On February 20, 1990, the defendant was notified to provide an accounting of the escrow funds and to return the funds. The defendant conducted a series of transactions on that day and the following day. On February 28, 1990, a Criminal Referral Form to the Federal Home Loan Bank Board on a suspected violation of misappropriation of escrow was submitted. The Court rejected the defendant's argument that the loss should be zero because he had fully refunded the escrow funds. He argued that the crime was discovered on February 28, 1990, the day the Criminal Referral Form was submitted and by then he had repaid the escrow funds with interest. The Court found that the crime was discovered on February 20, 1990, when the defendant was notified about the discrepancy in the escrow accounts. The Court clarified its earlier decision in *Allison* to hold that *Allison* only applies to amounts repaid by the defendant to the victim prior to discovery of the offense. Repayments do not apply to actual loss if they are made after discovery of the offense but prior to indictment. "Repayments before detection show an untainted intent to reduce any loss. Repayments after detection may show no more than an effort to reduce accountability." *Stoddard*, 150 F.3d at 1146.

Questions have arisen about changes in the value of assets securing a fraudulently procured loan after the assets are pledged. The question is whether this variation should affect the loss calculation. *See, e.g.*, *United States v. Barrett*, 51 F.3d 86, 90-91 (7th Cir. 1995) (including in loss the decline in the value of property securing fraudulently obtained loans).

A rule that gives credit for the value of collateral when it is pledged would ensure that fortuitous increases or decreases in the value of the property have no impact on the sentence. The current rule, however, specifies no fixed time for valuing collateral; it instructs the Court to reduce the loss figure by "the amount the lending institution has recovered (or can expect to recover) from any assets pledged to secure the loan." §2F1.1, comment. (n. 8(b)). A lender's decision regarding when to sell a foreclosed property can therefore significantly affect the loss amount.

5. <u>Diversion of Government Program Benefits</u>

Current rule: §2F1.1, n. 8(d) provides that in cases involving diversion of government program benefits loss is the "value of the benefits diverted from intended recipients or uses."

Issue: Should the Commission explicitly base loss in diversion cases on the value of the government benefits fraudulently obtained without deducting the value of the benefits that the defendant does allocate to "intended recipients or uses?"

Impetus: DOJ prosecutors indicated to us that the rule is not clear on whether total proceeds should be used, and that it is difficult to determine loss and gain, resulting in very small (if any) loss amounts in such cases. For example, in a kickback to a doctor who refers patients to a health care provider, it is difficult to determine loss, both because it is hard to prove that the patients received unnecessary services and because it is difficult to determine how much some alternative health care provider "lost." Similarly, it is difficult to determine the gain to the health care provider, assuming that net proceeds from the referred patients is likely to overstate the net gain. More recently a circuit court split has arisen about whether a "net" loss rule is applicable for these cases.

Case law: The appellate courts apparently are divided on whether loss calculations under §2F1.1, n.8(d) requires a "net" figure. In other words, depending on the circuit, the defendant may or may not receive a credit to the extent that the federal funds or benefits wrongfully obtained are allocated to the intended recipients or uses of the federal program from which the funds or benefits are purloined.

Two reported cases, *United States v. Adam*, 70 F.3d 776 (4th Cir. 1995), and *United States v. Henry*, 164 F.3d 1304 (10th Cir. 1999), used the value of gross benefits paid, rather than the value of benefits improperly received or diverted in determining the defendant's offense level under §2F1.1(b)(1).

The *Adam* Court declined to engage in fact finding as to what percentage of the Medicare funding spent on patients who were referred by the defendant doctor for certain tests pursuant to a kickback scheme was spent for appropriate purposes. However, *Adam* does not represent an actual circuit split since, for reasons that are unclear, the *Adam* Court did not decide the case in light of §2F1.1, comment. (n. 8(d)). Accordingly, the Court did not focus upon the "value of the benefits diverted from intended recipients or uses" as required by n. 8(d).

In *United States v. Henry*, the Court affirmed the District Court's calculation of the defendant's offense level based upon the gross amount of disability benefits received, rather than calculating the amount of benefits improperly received. Henry was convicted of filing false statements to obtain federal worker's compensation benefits. Henry was injured while employed as a construction worker for the Bureau of Prisons. In the course of receiving disability funds Henry regularly completed forms stating that he had not been employed, when in fact during brief periods he in fact worked. Had Henry completed the forms properly, acknowledging he had worked and earned limited income, he would have received a reduction in government benefits. The District Court increased Henry's base offense level by five levels to reflect the amount of gross benefits Henry received from the date of his first fraudulent statement up to his conviction. The dissent argued that "loss" in the Guidelines is the value of benefits diverted from intended recipients. The dissent wrote, "[t]he magnitude of Mr. Henry's crime is best measured by the amount of benefits he received unjustly as a result of incompletely filling out the . . . forms." "The government has a cause of action to forfeit the entire amount of benefits received in periods in which Mr. Henry supplied incorrect information...but this is different than saying that Mr. Henry's wrongful action caused a loss of the entire amount of benefits received." *Id*. at 1311.

Two circuits have followed a net approach that requires reducing loss by amounts properly going to intended recipients and uses. Two circuits have apparently refused to follow—or at least require—the net approach.

In *United States v. Peters*, 59 F.3d 732 (8th Cir. 1995), the defendant, who bilked the federal government under an asbestos abatement program, was not assessed loss for the funds that were utilized to actually remove asbestos from the premises of his client, a Nebraska school district. The loss was determined by calculating the amount of excess/false claims submitted to the government for payment, "the value of benefits diverted from intended recipients." *Id.* at 734. The defendant was not held accountable for the value of the benefits received and actually used for asbestos abatement. *Id.*

In *United States v. Rutgard*, 116 F.3 1270 (9th Cir. 1997), the Ninth Circuit remanded the case for resentencing due in part to the method the district court used to determine the amount of loss to be attributed to the defendant. The defendant, an ophthalmologic surgeon, was convicted of defrauding Medicare and other insurance programs by performing unnecessary medical treatments to patients and thereafter receiving payment from the insurance programs. Much of the evidence that inculpated the defendant came from 14 former employees that testified that the defendant: instructed employees to fill out patient complaint forms without seeing patients and to insert false visual field scores when patient's scored "too good"; and that a machine to test for the need for cataract surgery was "routinely set on 'high' in order to justify surgery," among other things. *Id*. at 1287-88. The district court found that the defendant's medical practice was "permeated with fraud," and calculated loss at over $10 million, as defendant had received over $15½ million from Medicare over an approximately four-year period when the fraud took place. *Id*. at 1276, 1290, 1294. In remanding the Ninth Circuit wrote "We have held that where misrepresented grapes were delivered the fraudulent broker must still be given credit for the value of the grapes he did deliver[, and a]nalogously, Rutgard must be given credit for the medical services that he rendered that were justified by medical necessity. As always, the burden is on the government to establish what services were not medically necessary." *Id*. at 1294.

In *United States v. Barnes*, 117 F.3d 328 (7th Cir. 1997), the Court held that the defendant, who had illegally discounted the value of food stamps in a cash-for-food stamps scheme, was not responsible for the gross value of all food stamps his retail store redeemed. Rather, the defendant received credit against loss for the value of the food stamps his store redeemed for items that could be legitimately purchased with food stamps. Interestingly, the scope of the credit was determined by an analysis of the defendant's documents that were submitted to the IRS for tax purposes. *Id.* at 334-35. His "gross sales" of food items was set off against the value of food stamps redeemed in his store to determine "legitimate food sales from food stamps coupon redemption." *Id.* The defendant received this amount in credit against his loss calculation. In this way his sentence was calculated only on the value of the government benefits "diverted from intended recipients or uses." *Id.*

In *United States v. Arnous*, 122 F.3d 321 (6th Cir. 1997), the Sixth Circuit remanded the case for resentencing because of an error in calculation of loss. The defendant was convicted of making a false statement in her application for participation in the food stamp program and for presenting false food stamp redemption claims. The district court found that the loss was the total amount of the food stamp redemption claims she submitted under the fraudulently-obtained authorization number. The Sixth Circuit's conclusions were two-fold. First, the Court found that properly authorized retail establishments could be considered "intended recipients or uses" for purposes of Note 8(d). The Court relied on the opinion in *Barnes*, which defined "intended use" as "the purchase of specified food products from authorized retailers." The Sixth Circuit, likewise, found that the amount of loss caused by the defendant's diversion was "the amount of the profits that properly authorized retailers failed to realize as a result of the business having gone to the [defendant] instead of to them." Second, the Circuit Court stated that the "net loss" should be the difference between the cost of the inventory to the other stores and the face amount of the food stamps. Accordingly, the Court vacated the Court's decision to base loss on the total amount of the food stamps rather than the net loss to authorized retailers.

6. $100 Minimum Loss per Credit Card[2]

Current rule: Application Note 4 to §2B1.1 provides "The loss includes any unauthorized charges made with stolen credit cards, but in no event less than $100 per card." Application Note 2 states that where the unlawful conduct involved a credit card, "the loss is to be determined under the principles set forth in the Commentary to §2F1.1." Application Note 8 to §2F1.1 states that if an intended loss figure can be determined, the figure will be used if it is greater than the actual loss. The April 1998 and 1999 versions of the proposed revised loss definition would extend this rule to all cases involving access devices. In 1999 the Treasury Department supported this change but recommended that the minimum loss for these cases be raised to $1,000 per card or access device, rather than $100.

Issue: Courts are taking a number of different approaches in determining loss in credit card cases. More specifically, there appears to be some confusion as to the application of Note 4 and the $100 loss per card rule, and inconsistency in the use of intended loss in such cases.

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[2]The Commission has voted to amend the minimum loss rule of Application Note 4 to §2B1.1 from $100 to $500 and to extend the rule to §2F1.1. A new application note extends the minimum loss rule to all unauthorized and counterfeit access devices, including credit cards and telecommunications identity information (including cellular phone identification numbers). The new $500 minimum loss amount applies to each access device with a limited exception for telecommunications identity information (if the stolen numbers are not used, the amount per stolen number is $100). The amendment was submitted to Congress May 1, 2000, and will become effective November 1, 2000, unless Congress rejects the amendment.

Case law: In *United States v. Yellowe*, 24 F.3d 1110 (9th Cir. 1994), the defendant was involved in a scheme to make unauthorized use of over 8,500 credit card numbers. The district court calculated loss by applying the $100 minimum to every "valid" credit card, which was approximately 90 percent of the cards. On appeal the defendant argued that the Court erred by not basing loss on his mistaken belief that only 12 percent of the cards would be valid and therefore could be used to commit fraud. The Ninth Circuit affirmed the district court's loss determination and added that the Court had given the defendant the benefit of the doubt by applying the $100 figure to only 90 percent of the cards. *Id.* at 1113. Similarly in *United States v. Say*, 923 F.Supp. 611, 614-15 (D.Vt. 1995), no actual losses occurred (cards were seized prior to being used) and the sentencing court calculated loss by utilizing the $100 per card figure.

Reported cases indicate several courts have calculated loss by estimating the intended loss by adding the available credit of each card involved in the fraud where courts had some basis for finding that intended loss was greater than the $100 per card minimum.

In *United States v. Dominguez*, 109 F.3d 675, 676-77 (11th Cir. 1997), the Eleventh Circuit found that where there is evidence that the defendant knew of the available credit on the credit cards involved in a fraud scheme, the amount of available credit is a reasonable estimate of the intended loss. The defendant knew of the available credit and the price charged per credit card in selling the cards by a co-conspirator was based on a percentage of the available credit on the card. *Id.* The defendant had contended that he should not be held liable for more than $100 per card, as there was no actual loss in the case since the cards were sold to government agents. The Eleventh Circuit found that the district court had not erred by estimating the intended loss to be the aggregate amount of available credit on the cards, in excess of $200,000. *Id.*

In *United States v. Engemonye*, 62 F.3d 425, 429 (1st Cir. 1995), the First Circuit affirmed the District Court's finding that the defendant was capable of and intended to fraudulently use the credit cards up to their available credit limits, and accordingly held the defendant accountable for the aggregate limits of the cards. The First Circuit found that where there is evidence of actual intent and some prospect of success, Courts do not need to indulge in forecasts as to the probable successfulness of the scheme. *Id.* The use of the aggregate credit limits of the cards for the amount of intended loss was affirmed. *Id.*

In *United States v. Sowels*, 998 F.2d 249 (5th Cir. 1993), *cert. denied*, 510 U.S. 1121 (1994), the Fifth Circuit held the defendant accountable for the aggregate credit limits of the 110 stolen credit cards he possessed in calculating the amount of intended loss. The defendant argued that the sentencing court should have only attributed a $100 loss per card since he had not made any unauthorized charges on the credit cards. The Fifth Circuit affirmed, finding that Note 4 instructs a sentencing judge to include unauthorized charges or at least $100 per credit card in determining loss, and that the note does not confine a sentencing court to these figures alone. *Id.* at 251-52. The Court found that the defendant's method of operation of selling or giving away the credit cards and the fact that the defendant was previously involved in making $28,540.89 in charges to 15 stolen credit cards over a one-week period "'increased the likelihood that the credit cards could have been charged to the maximum credit limit.'" *Id.* at 251 (quoting district court).

7. <u>Calculating Loss in Cellular Telephone Fraud Cases</u>[3]

Current rule: Generally, in cases sentenced under §2F1.1, if an intended loss figure can be determined that figure will be used for calculating base offense level if the intended loss exceeds actual loss. However, Circuit Courts have applied a range of industry and case-specific average loss figures as well as "actual" loss estimates in calculating the range of loss under §2F1.1. The different averages and standards applied lend themselves to sentencing disparities and confusion.

Issue: How should loss be determined in offenses involving cellular telephones and their components? Should the Guidelines provide, as recently recommended by the Treasury Department, that the rule for credit cards providing a minimum loss amount per credit card be applied in cellular telephone offenses on a per access device basis? (Under 18 U.S.C. § 1029(e)(1) the definition of an "access device" includes both credit cards and cellular telephone identifiers (electronic serial number ("ESN") and mobile identification number ("MIN"))).

Case law: The Sixth, Seventh and Ninth Circuits have affirmed sentencing courts' use of various average loss figures when calculating loss in cellular telephone fraud cases. Two Eleventh Circuit cases display the difficulty for Sentencing Courts when attempting to calculate actual and intended losses in cellular fraud cases. The court remanded two cases for resentencing when the sentencing court included loss figures attributable to particular cellular telephone identifiers connected to the defendants in determining loss, as the circuit court found that the proof linking the defendants (exclusive to other criminals) to the loss figures was unreliable or inconclusive.

In *United States v. Watson*, 118 F.3d 1315, 1317 (9th Cir. 1997), the Ninth Circuit affirmed the district court's estimation of actual loss which was based upon an actual average loss per telephone figure. Defendant Watson personally reprogrammed/cloned and sold cloned cellular phones. The actual average loss per telephone number ("ESN-MIN combination") figure ($3,030) was calculated based upon the losses incurred by each combination introduced during Watson's trial. Loss was computed by taking the number of ESN-MIN combinations found in Watson's home (that were apparently not used) times the average loss per combination. *Id.* at 1319. *See also United States v. Clayton,* 108 F.3d 1114, 1118-19 (9th Cir.)(affirming loss computed by adding together loss amounts reported by cellular telephone

[3]*See* Note 1, *supra*.

companies for each of the 29 cellular identification numbers defendant possessed), *cert. denied,* 118 S. Ct. 233 (1997).

In *United States v. O'Shield,* 1998 WL 104625 (7th Cir. March 6, 1998) (unpublished), the Seventh Circuit found that intended loss could be established based upon industry average loss amounts. The court affirmed a §2F1.1 loss calculation based upon the number of unauthorized cell phones the defendant sold and/or intended to sell times the industry average loss caused by an unauthorized cell phone. *Id.* at *7. The director of fraud management of a cell phone industry association (which represented 95 percent of the wireless phone service providers) testified that the average cloned phone caused $1,000 in losses to cellular phone providers. *Id.* at *3-4. The Seventh Circuit found that the standard industry loss amount of $1,000 times the 3,000 ESN-MIN combinations possessed by O'Shield provided a reliable estimate of intended loss for sentencing purposes ($3,000,000). *Id.* at *7-8.

In *United States v. Ashe,* 47 F.3d 770 (6th Cir.), *cert. denied,* 516 U.S. 859 (1995), the Sixth Circuit affirmed the actual loss calculation when based upon local average cell phone airtime usage and rates. Ashe sold 500 "tumbling" cell phones. *Id.* at 772. A tumbling cell phone contains a microchip which allows the user to utilize the cell phone without being charged for usage by circumventing a telephone companies ability to monitor usage and identify customers (known as "free riding" since the operator obtains a free ride on the system as the phone emits random ESN-MINs which are changed prior to the system identifying them as invalid). *Id.* The Sentencing Court calculated Ashe's offense level by taking the "average airtime consumption" in Chattanooga, Tennessee per cell phone customer and multiplying that number by the average access and per minute fees to obtain a monthly average per phone loss. Over the course of one year the loss for the 500 phones was set at $1,221,300. *Id.* at 775. The Sixth Circuit described the loss estimate as "very conservative" and found comfort in the reliability of the loss figure when it calculated that Ashe had taken in approximately $800,000 in selling the tumbling cell phones. *Id.* at 775-76.

In *United States v. Williams,* 128 F.3d 1239, 1241 (8th Cir. 1997), the court affirmed the calculation of loss wherein all losses incurred per cloned telephone numbers connected to the defendant were attributed to him in calculating loss. The defendant, Williams, sold cloned cell phones from 1994 to June, 1996. *Id.* at 1240. In order to calculate loss, victim cell phone companies identified all cloned telephones which placed calls to Williams between January and June 1996. *Id.* The sentencing court calculated total loss by summing up the charges for all calls made from these cell phones during that same six-month period. *Id.* On appeal, Williams contended that the Court's loss calculation improperly took for granted that he sold the cloned phones on which calls to him originated, arguing that he could have received calls from cloned phones he did not sell. *Id.* The Eighth Circuit affirmed, finding the loss estimate reasonable. *Id.* at 1241. Judge Morris Arnold wrote a concurring opinion wherein he wrote that the Court's calculation of loss did not measure loss that the victim suffered but instead calculated the telephone users' unlawful gain. *Id.* at 1242. The Eighth

Circuit's opinion appears to conflict with the Eleventh Circuit's opinions of *Sepulveda* and *Cabrera*, *infra*.

Two decisions by the Eleventh Circuit highlight the unique and substantial challenges presented when Courts attempt to determine loss amounts in cellular telephone fraud cases. The Court has remanded two cases for resentencing, *United States v. Sepulveda,* 115 F.3d 882 (11th Cir. 1997) and *United States v. Cabrera,* 172 F.3d 1287 (11th Cir. 1999), finding that proof linking the defendants exclusive to other criminals to the loss amounts was unreliable or inconclusive. In *Cabrera* the Court acknowledged that its holding may conflict with the Ninth Circuit's opinion of *United States v. Clayton,* 108 F.3d 1114 (9th Cir.), *cert. denied,* 118 S. Ct. 233 (1997). *Id.* at 1293.

In *Sepulveda* the defendants operated a "call sell" service utilizing cloned cellular telephones inside a clothing store. *Sepulveda,* 115 F.3d at 884. "Call sell" customers would be escorted to a dressing room by a clerk, the clerk would dial the number provided by the customer, and the customer would be charged by the minute for the call. *Id.* The evidence showed that the defendants possessed 17 cloned cell phones (containing cloned ESN-MIN combinations), 14 within the store and 3 inside a car trunk. *Id.* at 884 n.1. Also within the store officers recovered a hand written list of four ESN-MIN combinations. *Id.* at 885. Approximately $81,000 in unauthorized calls had been made by the ESN-MIN combinations the defendants possessed. *Id.* at 890. To prove which of the $81,000 in fraud should be attributed to the defendants, an expert conducted a "cell site" analysis which established that approximately $42,000 of the fraudulent calls originated from two sectors of a three sector cell site.[4]

The Eleventh Circuit remanded for resentencing, finding that the analysis relied upon by the sentencing court contained inherent uncertainties. *Id.* at 891. Test calls from the defendants' store indicated that the calls originated from only one of the three sectors of the cell site, not two (no mention was made of the cloned phones located inside the car trunk). *Id.* Additionally, the evidence indicated that originating calls can bounce between sectors and even sites when cell call activity is congested and a sector or site becomes overburdened. *Id.* at 890-91. The Court noted that due to possible sharing or related sources of codes, other unauthorized users may have made calls from the defendants' congested calling area/neighborhood and utilized the same ESN-MIN combinations, therefore, it was possible that other criminals unrelated to the defendants produced losses which may have been improperly attributed to the defendants. *Id.* at 891 n.28. The Court wrote that upon resentencing "[t]he government must . . . offer reliable, specific evidence estimating the volume

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[4] The defendants' store was located on the corner of the two sectors; the entire cell site covered an area of one to one and three quarter square miles–it is unclear what percentage of the cell site the two sectors covered.

of unauthorized calls [defendants] generated and the dollar amount reasonably attributed thereto." *Id.* at 892 n.29.

In *United States v. Cabrera*, the Sentencing Court calculated loss by attributing actual losses incurred by cell phone companies for the ESN-MIN combinations Cabrera possessed. Cabrera was convicted of possessing cell phone cloning equipment after he provided law enforcement officers with a list of ESN-MIN combinations he stated he had cloned and after officers seized a cloning operation located within the home Cabrera shared with a roommate. *Cabrera,* 172 F.3d at 1290-91. The government contended on appeal that the sentencing court had properly sentenced Cabrera and that he should be held responsible for losses associated with all of the ESN-MIN combinations he possessed, consistent with the Ninth Circuit's holding in *Clayton. Id.* at 1293. The *Cabrera* Court found that *Clayton* was distinguishable and wrote that "[t]o the extent that our holding conflicts with *Clayton*, however, we reject the proposition that the government can attribute the entire fraud loss associated with ESN/MIN combinations to the defendant solely because the defendant possessed those combinations. *Id.* The Court noted that multiple unauthorized users can use the same ESN-MIN combination simultaneously and that sellers of ESN-MIN combinations can provide the same combinations to multiple buyers. *Id.* at 1292.

B. Alternatives to Actual Loss

1. <u>Intended loss</u>

Current rule: Application note 8 to §2F1.1 instructs the Courts to use the higher of actual and "intended loss," a term not used in the §2B1.1 commentary, and in doing so, makes a reference to the attempt provisions in §2X1.1.

Issue: Should the Commission provide that credits should be applicable in determining intended loss and/or explicitly provide whether intended loss should be reduced by any amounts that could not have been obtained by the offense, or that the defendant was not reasonably capable of causing?

Impetus: Sprinkled throughout the commentary to §§2B1.1 and 2F1.1 are references to various alternatives to actual loss, and the guidelines are arguably unclear and inconsistent about when to use alternatives.

This discussion of alternatives to actual loss arguably has created some confusion in application. For example, in *United States v. Morris,* 18 F.3d 562, 570 (8th Cir. 1994), the Eighth Circuit considered "possible loss," a concept that does not appear anywhere in the guidelines. *Id.* In *United States v. Kopp,* 951 F.2d 521, 529-30 (3d Cir. 1991), the Third Circuit advocated using "intended loss" in *theft* cases, despite the Court's recognition that that term appeared only in the commentary to the *fraud* guideline.

Some courts have limited intended loss by a concept that they have called "economic reality" or by use of the amount actually "put at risk" (*e.g.*, reverse sting case; insurance claim in excess of fair market value).

Should the concept of intended loss be clarified? The Tenth Circuit refused to find a defendant responsible for an intended loss where government agents were the intended victims, finding that because loss was not possible under the circumstances there was no intended loss. *United States v. Galbraith*, 20 F. 3d 1054 (10th Cir.), *cert. denied,* 513 U.S. 889 (1994). *See United States v. Brown*, 151 F.3d 476 (6th Cir.) (must be possible for the defendant to cause the loss), *cert. denied,* 119 S. Ct. 560 (1998). Other Courts have found that the defendant does not have to be capable of incurring the intended loss. *United States v. Studevent*, 116 F.3d 1559, 1562 (D.C. Cir. 1997) (recognizing split in the Circuits); *United States v. Ismoila*, 100 F.3d 380, 396 (5th Cir. 1996) (fact that victims not at risk not dispositive), *cert. denied*, 520 U.S. 1219 (1997); *United States v. Bonanno*, 146 F.3d 502, 509-10 (7th Cir. 1998)(relevant inquiry is how much did the scheme put at risk, not how much would the defendant probably gotten away with); *United States v. Lorenzo*, 995 F.2d 1448, 1460 (9th Cir.) ("[T]he amount of [intended] loss . . . does not have to be realistic."), *cert. denied*, 510 U.S. 881 (1993).

In a contract procurement case, the question has arisen whether "expected loss" in application note 8(b) to §2F1.1 is always the full amount of the contract, or whether the defendant's ability and intent to perform the contract should play a role in loss calculation. *See United States v. Schneider*, 930 F.2d 555, 557-59 (7th Cir. 1991) (drawing distinction between defendant who intends to perform contract and defendant who intends to pocket proceeds and skip town).

In multiple victim cases, some courts have added intended loss to the amount of actual loss incurred.

In *United States v. Lauer*, 148 F.3d 766 (7th Cir. 1998), the defendant was the administrator of the Chicago Housing Authority's employee pension fund and diverted $15 million in pension funds to con men who ran a Ponzi scheme and induced other people to invest additional money. A total of $19.9 million was lost. Had the scheme not been discovered, an additional $5 million might have been lost. The Court determined loss by adding the $19.9 million in actual loss to the $5 million in additional intended, but unrealized loss, totaling $24.9 million. In reaching its loss figure, the Court stated, " [t]he briefs of the parties tacitly assume that the guidelines do not permit adding an actual to an intended loss--though the guidelines and their voluminous commentary do not address the issue...and the assumption is unwarranted in some cases. In some it is warranted." *Id*. at 767. The Court then found that in a case such as this where there are multiple victims, there can be no objection to adding the actual loss of one victim to the intended loss of another.

In *United States v. Brown*, 151 F.3d 476 (6th Cir.), *cert. denied*, 119 S.Ct. 560 (1998), the Court affirmed the determination that "loss" included both the amount of actual loss and intended loss. The Court wrote that three factors must be present under §2F1.1 for an amount of loss to be relevant: 1) the defendant must have intended the loss; 2) it must have been possible for the defendant to cause the loss; and 3) the defendant completed or was about to have completed, but for interruption, all acts necessary to bring about the loss. *Id*. at 489.

2. <u>Gain</u>

Current rule: Application note 9 to §2F1.1 provides that Courts need not determine loss "with precision" but "need only make a reasonable estimate of the loss, given the available information." It further provides that the "offender's gain from committing the fraud is an alternative estimate that ordinarily will underestimate the loss."

Issue: Should the Commission clarify the rule on use of gain as an alternative to actual loss and should gain be limited to "pecuniary" gain as used in Chapter Eight?

Impetus: Circuit court authority conflicts on the issue of when it is permissible to use the amount of the defendant's gain from unlawful activity when computing loss under §2F1.1(b)(1). The Fifth Circuit has stated that "if loss is either incalculable or zero, the district court must determine the §2F1.1[(b)(1) loss] by estimating the gain to the defendant as a result of his fraud." *United States v. Haas*, 171 F.3d 259 (5th Cir. 1999). Other Circuits have found that when there is no loss to the victim, the use of defendant's gain to compute loss under (b)(1) is improper. *United States v. Robie*, 166 F.3d 444, 455 (2d Cir. 1999)(use of defendant's gain for (b)(1) purposes improper if no economic loss to victim); *United States v. Brown*, 164 F.3d 518, 522 (10th Cir. 1998)("our cases state that relying on a defendant's gain is per se unreasonable only when the actual or intended loss is non-existent."(dicta)); *United States v. Adam*, 70 F.3d 776, 782 (4th Cir. 1995)(use of defendant's gain allowed since there was a financial loss to the government); *United States v. Andersen*, 45 F.3d 217, 220-21 (7th Cir. 1995)(gain may be used only as an alternative method of calculation when there is in fact a loss, and only if use of the gain results in a reasonable estimate of the loss).

In *United States v. Chatterji*, 46 F.3d 1336, 1341 (4th Cir. 1995), the Fourth Circuit found no loss where the prescription drugs that the defendant manufactured and for which he fraudulently gained FDA approval were just as effective as their FDA-regulated counterparts. *Id.* More importantly, the Court refused to use gain as an alternative to loss, finding that when loss is determined with certainty, gain is not to be substituted, even when loss is zero. *Id.* at 1342. In contrast, when drugs for which FDA approval was fraudulently obtained are *not* as good as their counterparts, gain may be used to measure loss. *See United States v. Marcus*, 82 F.3d 606, 610 (4th Cir. 1996) (holding manufacturer liable for over $10 million in gross proceeds as the proper measure of loss because the drug did not meet FDA specification and, thus, had no value).

In *United States v. Adam*, 70 F.3d 776, 782 (4th Cir. 1995), the Fourth Circuit using a *de novo* standard, distinguished *Chatterji*, and affirmed the district court's decision to use the amount of defendant's gain to determine the amount of loss. The defendant was convicted of receiving kickbacks paid out of welfare funds. The Fourth Circuit held that USSG §2F1.1, note 9 appears designed for just such circumstances because the amount of loss caused by the appellant's conduct cannot be determined with any certainty, but the amount of appellant's gain is an available, alternative measure of estimating that loss. The Fourth Circuit agreed with the government's argument that losses are almost always incurred when welfare fraud occurs because taxpayers must pay higher costs from kickback schemes, and that welfare fraud surely does impose enormous, unnecessary financial burdens on the public. Thus, because there was a loss to the United States, the defendant's gain could be used to calculate loss. *See also United States v. Castner*, 50 F.3d 1267 (4th Cir. 1995)(gain (illegal profit) could be used to calculate loss because the Navy did not receive the rigorously tested parts it bargained for under a supply contract).

The Eighth Circuit, in *United States v. Whatley*, 133 F.3d 601 (8th Cir.), *cert. denied*, 118 U.S. 2347 (1998), in a telemarketing case (wire fraud) was faced with determining the amount of loss to be attributed to the defendants. The case involved inducing victims to purchase anti-drug materials at inflated prices to donate to churches or schools. The victims were also promised prizes if they purchased the materials. In determining loss, the District Court took the gross revenues, minus money lost from refunds and checks on which payment was stopped, the money the company spent on prizes, and the money spent on the anti-drug products that were actually shipped to the schools. *Id.* at 606. The Eighth Circuit upheld the district court's refusal to reduce the loss by a "reasonable profit" and the over head of running the business, i.e., the costs of salaries for employees, of handling the prizes and the anti-drug products and of shipping those prizes and products. *Id.* The Court reasoned that the defendants were not entitled to a profit for defrauding people or a credit for money spent perpetrating a fraud.

The Second Circuit rejected the use of defendant's gain in calculating loss where the Court found the gain had no relation to loss. In *United States v. Robie*, 166 F.3d 444 (2d Cir. 1999), the defendant was employed by a company that produced stamps for the U.S. Postal Service. The defendant stole stamps which contained defects and sold them to stamp collectors. Due to the defects in the stamps, they should have been destroyed. The Sentencing Court found that the value of the stamps was $64,000, which was approximately the amount of money the defendant received for the stolen stamps. The Second Circuit remanded the case for resentencing, finding that if no economic loss occurred to the U.S. Postal Service, there was no loss for guideline calculation purposes. *Id.* at 455.

In *United States v. Brown*, 164 F.3d 518 (10th Cir. 1998), the Court affirmed the defendant's sentence when his offense level was computed by utilizing the amount of money the defendant gained by perpetuating the fraud ($650,000). The sentencing court found that the amount of actual loss had not been established by a preponderance of the evidence standard (the loss was reportedly between 18 and 25 million dollars). Instead, the Court used the amount of money the defendant gained by participating in a scheme selling worthless stock certificates. The Tenth Circuit affirmed and stated "our cases state that relying on a defendant's gain is *per se* unreasonable only when the actual or intended loss is non-existent." *Id*. at 522.

3. Risk of loss

Current rule: Guideline 2F1.1 is silent about including risk in the determination of loss, except application note 8(b) to §2F1.1 that suggests an upward departure when a defendant fraudulently obtains a loan, thus exposing the lender to the possibility of a loss, even though he pays it back before discovery of the fraud. This is based on the theory that at the time that a defendant receives fraudulent loan proceeds (*i.e.*, at the completion of the crime), the risk of loss is arguably the full amount of the loan, because there is no guarantee that any payments will be made or that any pledged security will retain its value. In fraudulent loan application and contract procurement cases, Courts are told to use "expected loss" if no actual loss has occurred, and may consider departures when the final loss figure does not adequately reflect the "risk of loss." *See* §2F1.1, comment. (n. 8(b)).

Issue: Should the Commission revise the loss definition to cover risk of loss? (For example, if a fraudulently obtained loan of $100,000 is collateralized with $50,000 of collateral, should the minimum loss amount be the $50,000 even if the payments and collateral reduced the actual loss to a lower figure?)

Impetus: At least one Court has found in a fraudulent loan case that the full loan amount can be used rather than the smaller actual loss amount. *See United States v. Brewer*, 60 F.3d 1142, 1145 (5th Cir. 1995) ("[W]e have found it proper to calculate loss based on the risk engendered by the defendant's criminal conduct, even where the actual loss was lower.")

Case law: In *Brewer* the Fifth Circuit reviewed an appellant's challenge to his counsel's failure to object to the use of the full amount of the $89,000 fraudulently obtained loan rather than the actual loss of $35,000 after sale of the real property collateral. The Court conceded that counsel should have filed an objection, but found no prejudice for two reasons. First, the Court stated that in fraudulent loan cases the guidelines advise that "loss is the actual loss to the victim or, where the intended loss is greater, the intended loss. USSG §2F1.1, Application Note [8](b)." *Id*. at 1145. The Court also observed that "applying this reasoning, we have found it proper to calculate loss based on the risk engendered by the defendant's criminal conduct, even where the actual loss was lower. *See, e.g., United States v. Wimbish*, 980 F.2d 312, 316 (5th Cir. 1992), *cert. denied*, 508 U.S. 919 (1993)."

Second, the Court reasoned that the two-level reduction that would have resulted, had the lower loss amount been used, would result in a maximum sentence reduction of six months, and the appellant's 30-month sentence "would remain within the new range." *Id*. The Court stated that it could not say there is “any probability that a lower sentence would have resulted.” *Id.*

C. Miscellaneous

The Department of Justice recommends an amendment that would provide that where the fraud guideline applies to bribery or commercial bribery cases, “the loss is the greater of the amount of the bribe or kickback or the value of the benefit received or to be received in return for the payment.” (p. 4)