IN THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

UNITED STATES OF AMERICA, Plaintiff, v. DANIEL BAYLY DAN O. BOYLE JAMES A. BROWN WILLIAM R. FUHS, and ROBERT S. FURST, Defendants	))))))))))	CR. NO. H-03-363 (Werlein, J.)

MERRILL LYNCH DEFENDANTS' MEMORANDUM REGARDING CALCULATION OF LOSS FOR PURPOSES OF SENTENCING

Defendants Daniel Bayly, James A. Brown, William R. Fuhs, and Robert S. Furst respectfully submit this memorandum setting forth their positions regarding loss for sentencing purposes. Although the Probation Office acknowledges that "assessing the loss or harm in this case is a very complex issue" (PSR Addendum at 35), the Presentence Report ("PSR") ultimately accepts as the amount of "intended loss" under the United States Sentencing Guidelines ("Guidelines") the $43.8 million figure advanced as "actual loss" by the government's expert, Professor Anthony Saunders. PSR Addendum at 35.

As we show below, Mr. Saunders's methodology – according to which loss is measured by the "artificial inflation" in the stock price caused by the alleged fraud – has been emphatically rejected by the courts, both in civil and criminal cases. Mr. Saunders's approach has also been repudiated both by the SEC and by the Department of Justice, and is flatly at odds with federal securities laws. And although the prosecutors and the Probation Office have doubtless scoured their law libraries and Internet sources, they have failed to unearth a **single** case that has **ever** adopted

"artificial inflation" as the measure of loss (whether actual or intended) for sentencing purposes. By contrast, **all** of the reported cases to have addressed the issue have flatly rejected Saunders's approach. In light of this overwhelming contrary authority, the PSR's adoption of Mr. Saunders's testimony as a measure of loss is deeply flawed.

Indeed, far from causing a loss, whether actual or intended, the Nigerian Barge Transaction richly benefitted Enron and its shareholders. Less than a year after the transaction with Merrill Lynch closed, Enron and its shareholders profited by more than $53 million when the Nigerian barges (as part of a package of nine barges in all) were finally sold to AES. The very *theory* of this prosecution was that the Merrill Lynch defendants were attempting to help Enron and its shareholders secure a *gain*, not a *loss*. Even if Merrill Lynch, by enabling Enron to book a portion of the eventual AES earnings in 1999, rather than 2000, impermissibly assisted in an *acceleration* of those earnings, the fact remains that the earnings were *real*, not fake. This was, in short, a case about an *accelerated gain*, not an actual or intended loss.

Under such circumstances – where neither actual nor intended loss can be shown – the Guidelines do not permit *any* kind of adjustment on account of loss, including an adjustment measured by the defendants' putative gain. Nor did the government prove any of the three alternative loss figures suggested by the PSR. One of those – a $12 million "loss" reflecting the gross earnings posted by Enron, allegedly improperly, in the fourth quarter of 1999 – reflects *gain* to the putative victim, not *loss*, and is obviously mistaken. A second alternative – $1,475,000 – includes $350,000 paid by AES, not Enron, and on account of a transaction (the sale by LJM2 to AES) for which the Merrill Lynch defendants were not responsible. Finally, the PSR and the government have alleged that Enron sustained a $775,000 loss because of the fees paid to Merrill

Lynch. While this figure at least finds some basis in the record, it too is overstated. For one thing, Enron paid Merrill Lynch only *$250,000*, with the balance paid by LJM2 (which the government does not allege to be a victim of the Barge Transaction). And even the $250,000 would have to be reduced to reflect the value to Enron of the use of Merrill Lynch's $7 million for six months. The resulting "loss" to Enron – even assuming that fees paid to Merrill Lynch are an appropriate barometer of loss – is zero.

One more introductory point: Because the proposed loss adjustment would have such an enormous effect on defendants' total sentence, the government should be required to prove the loss beyond a reasonable doubt. The preponderance standard is plainly inadequate under such circumstances. See, *e.g.*, *McMillan* v. *Pennsylvania*, 477 U.S. 79, 88 (1986) (suggesting that where a sentencing fact is "a tail which wags the dog of the substantive offense," the reasonable doubt standard may apply). Indeed, the Fifth Circuit has expressly recognized that "there may be certain cases where a sentencing fact is a 'tail that wags the dog of the substantive offense' and might arguably require a finding beyond a reasonable doubt." *United States* v. *Mergerson*, 4 F.3d 337, 344 (5th Cir. 1993) (quoting *McMillian*, 477 U.S. at 88).[1]

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[1] We recognize that the Fifth Circuit recently stated that sentencing courts after *Booker* may continue to apply a preponderance-of-the-evidence standard. *United States* v. *Mares*, No. 03-21035, 2005 WL 503715, at *7 (5th Cir. Mar. 4, 2005) ("The sentencing judge is entitled to find by a preponderance of the evidence all the facts relevant to the determination of a Guideline sentencing range and all facts relevant to the determination of a non-Guidelines sentence."). We note, however, that *Mares*'s language is not mandatory. In addition, the issue before the Fifth Circuit in *Mares* was whether the district court committed plain error. Moreover, the facts in *Mares* were not at all unusual, so the Fifth Circuit was not even confronted with a *fact-specific* situation in which a higher standard of proof might apply. And finally, *Mares* cites commentary to U.S.S.G. § 6A1.3 in which the Sentencing Commission simply noted *its* pre-*Booker* view that a preponderance standard is appropriate. See *id.* at *7 n.6. Accordingly, we urge this Court to apply a proof-beyond-a reasonable-doubt standard to *all* disputed facts in connection with Mr. Bayly's sentencing. See *United States* v. *Huerta-Rodriguez*, 355 F. Supp. 2d 1019, 1028-29 (D. Neb. 2005) ("Whatever the

At the very least, the clear and convincing standard should apply. See *United States* v. *Jordan*, 256 F.3d 922, 927-28 (9th Cir. 2001) (clear-and-convincing standard applies to sentencing enhancement that has a "disproportionate impact" on sentence); *United States* v. *Townley*, 929 F.2d 365, 370 (8th Cir. 1991) (suggesting that a sentencing factor that produces an 18-level increase may require clear-and-convincing evidence before it can be applied); *United States* v. *Concepcion*, 983 F.2d 369, 394 (2d Cir. 1992) (Newman, J., concurring) ("[A] strong argument can be made that the 'clear and convincing evidence' standard should be used, at least for substantial enhancements [under the Guidelines].").

In all events, the standard of proof must be applied with particular care and rigor. Just as in narcotics cases – where the quantity of drugs may entail an enormous difference in prison time – "[c]ourts must sedulously enforce the quantum-of-proof rule," as even a modest difference in loss calculation "has a dramatic leveraging effect." *United States* v. *Sepulveda*, 15 F.3d 1161, 1198 (1st Cir. 1993). "[D]istrict courts must base their findings on 'reliable information' and, where uncertainty reigns, must 'err on the side of caution.'" *Ibid.* (quotation omitted).

When all is said and done, the government's loss position – which the PSR uncritically adopts – is long on rhetoric but short on legal support. According to the prosecutors, a stiff sentence is necessary, even if the law says otherwise, in order to "demonstrate that the defendants are not

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constitutional limitations on the advisory sentencing scheme, the court finds that it can never be "reasonable" to base any significant increase in a defendant's sentence on facts that have not been proved beyond a reasonable doubt."); see also *United States* v. *Harper*, No. 1:04-CR-90, 2005 WL 646366, at *3 (E.D. Tex. March 17, 2005) ("In spite of the Fifth Circuit's recent decision in *Mares*, this court must respectfully conclude that the even more recent Supreme Court decision in *Shepard* [v. *United States*, __ U.S. __, 2005 WL 516494 (March 7, 2005)], requires that sentence enhancements under the guidelines require more than inferences drawn from a preponderance of the evidence.")

above the law." Gov't Mem. In Aid Of Sentencing Defendants Bayly And Brown ("Gov't Mem.") at 3. But the Merrill Lynch defendants are asking to be treated *according* to the law, not above it. It is the government that is asking the Court to make a special exception to settled legal principles for this case. Like "a restricted railroad ticket, good for this day and train only" (*Smith* v. *Allwright*, 321 U.S. 649, 669 (1944) (Roberts, J., dissenting)), the PSR and the government ask this Court to do what no other court has ever done and likely never will. For the reasons we set out below, the Court should decline the invitation.

SUMMARY OF ARGUMENT

The recommendations on loss advanced by the Probation Office and by the government are flawed at every turn. Briefly stated:

- Virtually every circuit court, **in both civil and criminal cases alike**, has held that "artificial inflation" in a stock price is insufficient to prove loss, without further proof that the stock price declined when the fraud was publicly disclosed and that shareholders lost money as a result. In this case, there is absolutely no evidence that the price of Enron stock dropped in the wake of any disclosure of fraud in the Barge Transaction. For that reason, it is hardly surprising that **all** Professor Saunders even **attempted** to show is artificial inflation. Significantly, in a brief submitted to the United States Supreme Court in *Dura Pharmaceuticals, Inc.* v. *Broudo*, No. 03-932, the Solicitor General of the United States, filing on behalf of both the Department of Justice and the SEC, expressly repudiated **precisely** the theory of actual loss propounded by the government (and Mr. Saunders) in this case.

- For much the same reasons, the government's proof of "intended loss" falls short in this case. "Intended loss," in this Circuit and elsewhere, requires the government to prove that "the defendant had the subjective intent to cause the loss that is used to calculate his offense level." *United States* v. *Sanders*, 343 F.3d 511, 527 (5th Cir. 2003). Even assuming that the government has proved that the Merrill Lynch defendants intended to help Enron artificially inflate its stock price for a brief period in fiscal year 1999, such artificial inflation alone – without proof that the Merrill Lynch defendants *also* intended that Enron shareholders *lose* that artificial inflation on account of the fraud – does not prove loss.

- The notion that the Merrill Lynch defendants "subjectively intended" to cause *any* loss to Enron shareholders, much less the gargantuan $43.8 million loss that the PSR

recommends, is absurd. Indeed, the prosecution's theory was that the Merrill Lynch defendants, by providing a "bridge" to a permanent investor, intended that Enron and its shareholders would be able to recognize a *gain* – a *genuine* gain – but on an (impermissibly) accelerated basis. Whatever else may be said about such an arrangement, "intended loss" is entirely the wrong description. And, of course, as events turned out, Enron did indeed earn a hefty profit on the barges, and there is no proof that the Merrill Lynch defendants intended otherwise.

- Although the Probation Office and the prosecutors dispute that civil cases provide an appropriate precedent for determining "loss" in a criminal securities case, they ignore the fact that *criminal* cases have applied the very same standard for which we are contending. And tellingly, neither the prosecutors not the Probation Office has located a **single** case that has ever measured loss – whether actual or intended – according to the amount of artificial inflation in the stock price. This Court should decline the government's invitation to become the first to adopt this untenable theory.

- Because there is no provable loss (whether actual or intended) in this case, the Guidelines prohibit any adjustment for loss – even a loss measured by gain to the defendants.

- Although we do not believe that any adjustment for loss is warranted, the most that is even arguable is the lesser of (i) Professor Fischel's valuation of an imputed put or (ii) the net fees paid by Enron to Merrill Lynch on account of the Barge Transaction, which, when accurately calculated, are zero. The alternative measures of loss suggested by the PSR Addendum (at 38) – although certainly less preposterous than the $43.8 million figure – are nevertheless unsupportable.

- If, notwithstanding the arguments set forth below, the Court accepts the recommendation of the PSR that intended loss is $43.8 million, it should grant a downward departure (or impose a non-Guidelines sentence) so that there is no adjustment on account of loss.

I. THE FEDERAL COURTS HAVE UNIFORMLY REJECTED "ARTIFICIAL INFLATION" IN STOCK PRICE AS A BASIS FOR MEASURING LOSS IN CIVIL AND CRIMINAL CASES

A. Mr. Saunders Measured Loss According To How Much The Alleged Fraud "Artificially Inflated" The Price Of Enron Stock

It is important to be clear, at the outset, exactly what Mr. Saunders has argued. As the PSR correctly perceives, Mr. Saunders's basic contention is that, by virtue of the barge transaction, "all

investors who purchased Enron shares after the announcement of Enron's fourth quarter 1999 and fiscal year 1999 earnings, up until Enron's collapse in November 2001, may have paid too much for their shares because of the Nigerian barge transaction." PSR ¶ 66. According to Saunders's testimony, "[a]nybody who bought shares in that period w[as] damaged[.]" Tr. 6677. Applying an array of controversial analytical techniques, Saunders derived the amount of alleged inflation in the stock price – 47¢ per share. Saunders then multiplied that 47¢ per share by the number of shares he thought had been purchased during the three-month period following the announcement of earnings for the fourth quarter of 1999. Tr. 6708-09. The product of the two figures is $43.8 million.

Significantly, Saunders asserted that this alleged artificial inflation remained in Enron's stock price because, long before the barge deal was publicly disclosed to have been a fraud, Enron went into bankruptcy for wholly unrelated reasons. Tr. 6709. As Saunders explained, the 47¢ inflation remained embedded in the stock price straight through the date of bankruptcy – "the inflation is there, and it stays there * * * until the fraud is revealed. And the fraud was not revealed." Tr. 6717. "In fact," Saunders stated, "the fraud went on and on and on and never truly was revealed until, actually, I think, yesterday. So it's been there all the time – impounded and built into the stock price." Tr. 6740. See also Saunders Rep. 33 ("It is my understanding that this transaction and its fraudulent effects on Enron's earnings were not disclosed until after Enron's bankruptcy. Thus, the misleading accounting consequences of the Nigerian barge transaction were never purged from the

pricing of Enron's stock; instead investors continued to purchase Enron shares at prices inflated by the Nigerian barge fraud up to the bitter end.").[2]

The government's theory of "loss" at trial was likewise based entirely on the alleged inflation in Enron's stock price. As AUSA Ruemmler put it in summation: "Enron's investors were tricked into paying more money for the stock than it was really worth, and this fraudulent Nigerian barge deal was part of that lie." Tr. 6900. See also Tr. 6959 ("But when you pay too much for something, you lose money, and the shareholders of Enron, Professor Saunders' analysis proved, paid too much money."). The government did **not** contend that investors **lost** the inflation in the value of their stock as a result of the fraud. Indeed, the prosecutors could not have made such an argument, since their only witness – Professor Saunders – asserted that Enron investors lost the value of their investment **not** because of the Nigerian barge deal, but because unrelated, intervening events caused Enron to spin into bankruptcy. See also Government's Consolidated Response to Defendants' Pretrial Motions at 50 (conceding that "there is no claim" in this case "that the barge deal caused Enron's collapse") (attached as Ex. A).

The PSR itself notes the same point. "The Nigerian barge fraud," the report observes, "was not a typical security fraud case, in which the loss to investors was readily discernable by comparing

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[2] The government now finds it "obvious that, had he been asked directly, Professor Saunders would agree that investors lost the artificial inflation in stock price when the stock became worthless * * *." Gov't Mem. at 26 n.9. Of course, the fact that Saunders was not "asked directly" about this issue is hardly the defendants' fault, since the government presented the "direct" examination of Saunders. The prosecutors – who, after all, bear the burden of proof on loss – never asked Saunders this question because it evidently never dawned on them that loss causation is an element of loss. Moreover, it is not at all clear why Saunders would have "obvious[ly]" given the testimony that the government now proffers, since it is so plainly wrong as a matter of law. Investors do **not** lose the "artificial inflation" in stock price when a company's stock price becomes worthless *for unrelated reasons*. Indeed, as we show below, the Department of Justice made that very point in its Supreme Court filing in *Dura Pharmaceuticals*.

the stock rise, after the significant event, to the stock decline, after the fraud was discovered. The Nigerian barge fraud was not discovered, **until after the stock plummeted for other reasons**." PSR ¶ 82 (emphasis added).

As we show below, proof of artificial inflation alone – without proof that a disclosure of the fraud caused the inflation to leave the stock price – does not establish loss, either in civil or criminal cases. We direct the balance of Point I to that presentation. By focusing on this fatal weakness in Saunders's analysis, however, we would not wish to suggest that this is the only thing wrong with his argument.[3] To the contrary, both his derivation of the amount of inflation, and his determination of the number of damaged shares, are the worst sort of junk science.[4]

For example, Saunders paid no attention to the fact that, by the end of 2000, Enron had sold the barges to AES for an enormous profit, and thus, by that point if not sooner, any "inflation" in Enron's stock price was no longer "artificial" (if it ever was) – it was real, reflecting a legitimate profit-making venture. Thus, Saunders's belief that the 47¢ artificial inflation remained in the stock up through the declaration of bankruptcy cannot be squared with reality. Saunders's analysis also took no account of so-called "confounding" information – public disclosures that complicate the ability to assess just how much inflation there is in a stock price. Among other things, he made no mention of Enron's announcement, only two days after the January 18 disclosure of fourth quarter

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[3] We wrote that very same sentence of text in our previously filed objections to the initial PSR, and the government has obviously reviewed our filing. Nevertheless, the government sees fit to assert – and assert repeatedly – that we did "not dispute that the Nigerian barge fraud directly caused the artificial inflation of Enron stock in a determined amount of $43.8 million." Gov't Mem. at 10, 11, 26 n.9.

[4] In that connection, we incorporate by reference the arguments contained in our *Daubert* challenge to the testimony of Mr. Saunders (Doc. 586).

earnings, that it was launching an Internet broadband initiative that was expected to generate hundreds of millions of dollars of revenue, and which resulted in an immediate jump in Enron's stock price. Tr. 3782-83, 3913, 3962. Saunders likewise took no account of the impact on earnings and stock price "inflation" arising from Merrill Lynch's $7 million payment. And Saunders's choice of 93 million as the number of allegedly damaged shares – simply because that was the number of investors who ostensibly purchased during the three-month period following January 18, 2000 – is no better than drawing a lotto number from a bin.

But grave as they are, these errors pale beside Saunders's (and the government's) failure to understand a basic legal principle: Under the law – as applied with equal force in both civil and criminal cases – **mere artificial inflation in stock price does not prove loss.** To prove loss the government must also show that the artificial inflation was removed from the stock price because of a public disclosure of the alleged fraud. Neither Saunders, nor the prosecutors, have even attempted to offer such proof in this case. Indeed, they could not do so – since the available evidence confirms that Enron shareholders did not lose, but instead profited, on account of the Nigerian Barge Transaction.

B. The Federal Courts, In Both Civil And Criminal Cases, Have Emphatically Rejected Artificial Inflation As A Basis For Measuring Loss

1. Civil Cases

Even if one accepts all of Professor Saunders's analysis – as absurd as it otherwise is – all he even **purports** to show is the artificial inflation in Enron's stock price as a result of the barge deal. But with the single exception of the Ninth Circuit – in a case that the Supreme Court has just reviewed and is likely to reverse – every circuit has held that an investor **cannot** prove loss by proving merely that the stock price was artificially inflated by fraud. Rather, the investor must prove

what the federal securities laws call "loss causation." Under this principle, an investor can establish loss only if he can show that he **lost** the inflation in his stock price once the fraud was publicly revealed in some fashion. Absent a showing of loss causation, the law assumes that the investor can simply sell his inflated stock to someone else and recoup full (if inflated) value. And even when such a resale cannot be effected – for example, because the company has gone bankrupt in the meantime for unrelated reasons – the law does not recognize any loss for the shareholders. In that scenario, although a shareholder may have relied on fraudulent representations in purchasing his stock, his *losses* were sustained for other reasons.

a. *Statutory Background.* Until the enactment of the Private Securities Litigation Reform Act ("PSLRA") in 1995, the private right to sue under Section 10(b) and Rule 10b-5 was entirely a judicial creation. That cause of action was first recognized in *Kardon* v. *National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946), and soon became an established feature of federal securities regulation. See *Herman & MacLean* v. *Huddleston*, 459 U.S. 375, 380 & n.10 (1983) ("The existence of this implied remedy is simply beyond peradventure."). Just as the federal courts created the right without congressional guidance, they shaped the contours of that right largely on their own as well. See *Musick, Peeler & Garrett* v. *Employers Ins. of Wausau*, 508 U.S. 286, 292 (1993). In so doing, judges looked primarily to common law tort principles, which supplied the basic, and now well-accepted, elements of the 10b-5 action. See, *e.g.*, *Basic Inc.* v. *Levinson*, 485 U.S. 224, 231-41 (1988) (materiality); *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 196 (1976) (scienter); *List* v. *Fashion Park, Inc.*, 340 F.2d 457, 462-63 (2d Cir. 1965) (reliance); see generally *Mitchell* v. *Tex. Gulf Sulphur Co.*, 446 F.2d 90, 97 (10th Cir. 1971) (noting that "the full panoply of common law fraud elements . . . have crept in and played varying roles of significance" in 10b-5 cases).

Loss causation emerged from the same process; it was originally articulated as an independent requirement in *Schlick* v. *Penn-Dixie Cement Corp*., 507 F.2d 374 (2d Cir. 1974). *Schlick* was the first case expressly to distinguish between "loss causation," which the court defined as a showing that "the misrepresentations or omissions caused the economic harm," and "transaction causation," defined as a showing "that the violations in question caused the [plaintiff] to engage in the transaction in question." *Id*. at 380. Transaction causation is synonymous with reliance and generally corresponds with the tort law concept of "causation in fact" or "but for" causation. See *Binder* v. *Gillespie*, 184 F.3d 1059, 1065-66 (9th Cir. 1999); *Shapiro* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc*., 495 F.2d 228, 239-40 (2d Cir. 1974). Whereas reliance focuses on the relationship between defendant's misrepresentations and plaintiff's investment decision, loss causation "requires one further step in the analysis: even if the investor would not otherwise have acted, was the misrepresented fact a proximate cause of the loss? The plaintiff must prove not only that, had he known the truth, he would not have acted, but in addition that the untruth was in some reasonably direct, or proximate, way responsible for his loss." *Huddleston* v. *Herman & MacLean*, 640 F.2d 534, 549 (5th Cir. 1981) (internal citation omitted), *aff'd in part and rev'd in part*, 459 U.S. 375 (1983).

From its inception, therefore, the loss causation requirement was intended to prevent plaintiffs from recovering in securities litigation merely because they were lured into transactions that proved losers; instead the loss itself must have been linked – in some direct or foreseeable way – to the defendants' fraud. See *Rousseff* v. *E.F. Hutton Co.*, 843 F.2d 1326, 1329 n.2 (11th Cir. 1988); *Mfrs. Hanover Trust Co.* v. *Drysdale Sec. Corp*., 801 F.2d 13, 20-21 (2d Cir. 1986). For this reason, loss causation is often described as an analogue to the general common law principle of

proximate cause. See *Citibank, N.A.* v. *K-H Corp.*, 968 F.2d 1489, 1495 (2d Cir. 1992); *Weiss* v. *Wittcoff*, 966 F.2d 109, 111 (2d Cir. 1992). Like loss causation, proximate cause insulates against the sometimes harsh consequences of strict but-for causation, which can lead to absurd and unjust results. And indeed, in analogous common law fraud cases, the generally accepted understanding of proximate cause would rule out causation on the theory accepted by the PSR in this case:

> [O]ne who misrepresents the financial condition of a corporation in order to sell its stock will become liable to a purchaser who relies upon the misinformation for the loss that he sustains when the facts as to the finances of the corporation become generally known and as a result the value of the shares is depreciated on the market, because that is the obviously foreseeable result of the facts misrepresented. On the other hand, *there is no liability when the value of the stock goes down after the sale, not in any way because of the misrepresented financial condition, but as a result of some subsequent event that has no connection with or relation to its financial condition*. There is, for example, no liability when the shares go down because of the sudden death of the corporation's leading officers. Although the misrepresentation has in fact caused the loss, since it has induced the purchase without which the loss would not have occurred, *it is not a legal cause of the loss for which the maker is responsible*.

RESTATEMENT (SECOND) OF TORTS § 548A (1977) (emphases added); see also PROSSER AND KEETON ON TORTS § 110 (5th ed. 1984). This common law backdrop illustrates that the loss causation requirement represents a policy judgment that defendants in securities fraud cases should not be held liable for those investment losses that stem from wholly unrelated sources, *i.e.*, losses that are a genuinely unexpected or unforeseeable result of the original misrepresentation.

The PSLRA codified this loss causation requirement. S. REP. NO. 104-98 at 15 (1995). Section 21D(b)(4) provides that "[i]n any private action arising under this chapter, the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages." 15 U.S.C. § 78u-4(b)(4).

b. *The Case Law*. Consistent with the governing statute, the federal courts of appeals have held – with near uniformity – that mere artificial inflation is simply not enough to prove loss in a securities fraud case. *Robbins* v. *Koger Prop., Inc*., 116 F.3d 1441 (11th Cir. 1997), is a compelling example. *Robbins* concerned a company's use of overcapitalization (and fraudulent accounting) to boost its apparent cash flow and pay higher dividends. These dividends in turn drove up the company's stock price. Eventually, the board of directors was forced to cut dividends for unrelated reasons (a deteriorating real estate market), which drove down the value of the stock. The court of appeals held that loss causation was not satisfied and thus granted defendants' post-trial Rule 50(a) motion for judgment as a matter of law. The court reached this result even though it found that plaintiffs may have offered sufficient evidence to allow the jury to conclude that the misrepresentations artificially inflated the stock price during the class period. See 116 F.3d at 1447-48. "This showing of price inflation, however, does not satisfy the loss causation requirement. Our cases do not hold that proof that a plaintiff purchased securities at an artificially inflated price, without more, satisfies the loss causation requirement." *Id*. at 1448. Instead, in a case such as this, loss causation requires a showing that the fraud was a "substantial, *i.e*., a significant contributing cause," of the ultimate stock downturn, that is of the actual economic loss. *Id.* at 1447.

The Third Circuit took the same position in *Semerenko* v. *Cendant Corp*., 223 F.3d 165 (3d Cir. 2000). *Semerenko* involved alleged misrepresentations about Cendant Corporation made during a tender offer that the company was making for shares of American Bankers Insurance Group ("ABI"). The plaintiffs, who had purchased ABI stock during this period, contended that the falsehoods artificially buoyed the price of the shares and then caused a corresponding decline when they were disclosed and the merger agreement was terminated. The Third Circuit held that these

allegations were sufficient to show both transaction causation and (separately) loss causation. As to the latter, the court observed that, although its previous cases had suggested that artificial inflation was sufficient to satisfy loss causation, in fact those decisions "assume that the artificial inflation was actually 'lost' due to the alleged fraud." 223 F.3d at 185. Relying on *Robbins*, the Third Circuit went on to make clear that an investor must "establish that the alleged misrepresentations proximately caused *the decline in the security's value* to satisfy the element of loss causation." *Ibid.* (emphasis added). The allegations in *Semerenko* were sufficient because the plaintiffs contended not merely that the price of the shares they bought were inflated, but *further* that they "suffered a loss when the truth was made known and the price of ABI common stock returned to its true value." *Id*. at 185.

The Second Circuit – the leading circuit for securities litigation – has likewise held that an "allegation of a purchase-time value disparity, standing alone, cannot satisfy the loss causation pleading requirement." *Emergent Capital Inv. Mgmt., LLC* v. *Stonepath Group, Inc*. 343 F.3d 189, 198 (2003). Indeed, in a thorough opinion issued only two months ago, the Second Circuit rejected exactly the loss argument proffered by the government in this case. *Lentell* v. *Merrill Lynch & Co. Inc*, 396 F.3d 161 (2d Cir. 2005). The plaintiffs in that case brought an action against Merrill Lynch and one of its former analysts, alleging that the defendants had urged them to purchase certain securities without revealing that they did not believe the investments to be worthwhile. The Second Circuit, affirming a motion to dismiss, held that the plaintiffs had not pleaded loss causation. Like Professor Saunders, the plaintiffs in *Merrill Lynch* alleged that the defendants' fraud had "'induced a disparity between the transaction price and the true "investment quality"'" of the securities. *Id.* at 175. As a result, the plaintiffs contended, "'the market price of [the] securities was artificially

inflated'" and remained so until – for other reasons – "the shares plummeted, and * * * their investments became virtually worthless." *Ibid.* But as the Second Circuit explained, such a showing **does not even warrant discovery in a civil securities case** (much less prison time in this case). Because the plaintiffs had failed to allege that "'the subject of the fraudulent statement or omission was the cause of the actual loss suffered,'" they had failed "to establish loss causation," and thus could not proceed with the case. *Id.* at 173. See also *id.* at 175 (without an allegation that "the market reacted negatively to a corrective disclosure regarding the falsity of [Merrill Lynch's] 'buy' and 'accumulate' recommendations," a mere allegation of misrepresentations to the market does not prove loss).

Finally, it bears mention that this Circuit as well has cast serious doubt on the use of artificial inflation to measure loss in a securities case. In *Huddleston*, after observing that loss can be shown only where the "misrepresentation touches upon the reasons for the investment's *decline in value*," the court gave an example where, although the investor purchased stock in reliance on misrepresentations that made the investment appear more valuable than it was, loss causation did not exist because the *subsequent decline* in the stock's price was not traceable to the fraud. 640 F.2d at 549 & n.25 (emphases added).[5]

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[5] Similarly, in *Bastian* v. *Petren Resources*, 892 F.2d 680 (7th Cir. 2002), the Seventh Circuit concluded that loss causation required a post-transaction decline in the value of the investment related to the misrepresentations or omissions. See *id.* at 684-85 ("If the plaintiffs would have lost their investment regardless of the fraud, any award of damages to them would be a windfall."). And one district court has relied on an unpublished Sixth Circuit decision to conclude that loss causation in that circuit "requires the plaintiff to point to some causal link between the alleged misrepresentations and *a concrete decline in the value of the plaintiff's stock*." *D.E. & J. Ltd. P'ship* v. *Conaway*, 284 F. Supp. 2d 719, 748 (E.D. Mich. 2003) (emphasis added) (citing *Campbell* v. *Shearson/American Exp. Inc.*, 829 F.2d 38, 1987 WL 44742 (6th Cir. 1987) (unpublished)).

In the entire country, only one court – the Ninth Circuit Court of Appeals – has held that artificial inflation alone suffices to prove loss in a securities fraud case. But the United States Supreme Court has granted certiorari in that case, and the oral argument indicates that the Supreme Court is likely to reverse the Ninth Circuit's decision. See Oral Argument Tr. at 36-37, 39, 50-51, *Dura Pharmaceuticals, Inc.* v. *Broudo* (No. 03-932), http://www.supremecourtus.gov/ oral_arguments /argument_transcripts/03-932.pdf.

c. *The Solicitor General of the United States Has Repudiated The Loss Theory Applied In This Case.* Significantly, **the United States filed a brief in the *Dura Pharmaceuticals* case as amicus curiae and flatly rejected the very theory of loss that Mr. Saunders has propounded in this case**. In that brief – filed on behalf of both the Department of Justice and SEC – the government told the Supreme Court:

> In the Ninth Circuit, a plaintiff in a fraud-on-the-market case can establish loss causation merely by pleading and proving that he purchased the security at a price inflated by the defendant's misrepresentation. **That standard is incorrect**. As other circuits have recognized, there is no loss causation in a fraud-on-the-market case unless the truth was subsequently revealed and the inflation attributable to the misrepresentations was thereby removed from the price of the security to the injury of the plaintiff. * * *
>
> The Ninth Circuit's standard rests on the premise that the loss caused by a misrepresentation occurs at the time of the transaction, when the investor pays "too much" for the security. **The premise is mistaken**, because an investor can fully recoup his overpayment by reselling the security at the prevailing inflated price, and thus does not suffer *any* loss at the time of the purchase, much less one caused by the misrepresentation.

Brief for the United States as Amicus Curiae Supporting Petitioners at 7 (emphasis added).

In its amicus filing, the United States also addressed the scenario at issue in the present case – where, sometime after the alleged fraud, but before the fraud has been disclosed, the value of the stock "plummet[s] for other reasons." PSR ¶ 82. The government explained that in this situation,

too, there is no loss causation, and the investor cannot recover. As the government put it, quoting from the Restatement of Torts, if "the value of the stock goes down," for example, "'because of the sudden death of the corporation's leading officers' – there is 'no liability.'" Brief for the United States at 18. Likewise, the United States contended, "'[i]f false statements are made in connection with the sale of corporate stock, losses due to a subsequent decline in the market, **or insolvency of the corporation brought about by business conditions or other factors [that] in no way relate to the representation[,]** will not afford any basis for recovery.'" *Id*. at 19 (emphasis added).[6] "As the Restatement explains, '[a]lthough the misrepresentation [in such a case] has in fact caused the loss,' in the sense that 'it has induced the purchase without which the loss would not have occurred,' the misrepresentation 'is not a legal cause of the loss for which the maker is responsible.'" *Id*. at 19 (quoting Restatement of Torts § 548A cmt. b).

The Enron Task Force is now attempting to reconcile its arguments at trial with what the Solicitor General said about "loss" in *Dura Pharmaceuticals*. The prosecutors attribute the differences to some pertinent distinctions between the two underlying statutes – the PSLRA in *Dura* and the Sentencing Guidelines in this case. But there is no relevant distinction between the two statutes in terms of what "loss" means in a securities case. Section 2F1.1 of the Guidelines directs the court to determine "loss," and that term has a settled meaning under the federal common law developed in securities cases. *Community for Creative Non-Violence* v. *Reid*, 490 U.S. 730, 739 (1989) (statutory terms that have a common law antecedent presumptively carry the same meaning

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[6] The Enron Task Force asserts in its memorandum (at 17) that artificial inflation does **not** remain "embedded in the stock price" when the "stock price declines all the way to zero, perhaps because of a severe downturn in the economy, without explicit disclosure of the fraud." That, of course, is the very proposition the Solicitor General rejected in the sentence just quoted in the text.

as at common law). And every reported decision – including, as we next show, criminal cases – has understood loss to embody the concept of loss causation.

2. Criminal Cases Measuring Loss For Sentencing Purposes

The foregoing principles for measuring loss in *civil* securities fraud cases apply with equal force in *criminal* securities fraud cases for purposes of measuring loss under Section 2F1.1. Indeed, to our knowledge, **every reported case has rejected artificial inflation as an appropriate means of measuring "loss" under U.S.S.G. § 2F1.1(b)**.[7] This case should not break ranks with that uniform weight of authority.

Judge Breyer's decision in *United States* v. *Grabske,* 260 F. Supp. 2d 866 (N.D. Cal. 2002), provides a thorough roadmap. The defendants in that case were convicted of providing false financial information to the market, thereby fraudulently inflating the value of the company's stock. In determining the amount of the "loss" for purposes of Section 2F1.1, the court pointedly rejected the government's submission – propounded by one of the very prosecutors making the same argument anew in this case – because "the government ha[d] not adequately explained how defendant's fraud *caused* [the company's] investors to lose $1.9 million." 260 F. Supp. 2d at 869. Quoting from one of the leading *civil* cases – in which summary judgment was awarded to the defendant on loss causation grounds – Judge Breyer explained that, without a showing of loss causation, artificial inflation simply does not measure actual loss:

> As one court has explained, if the fraudulent statements "were successfully covered up, they were never disclosed to the market and therefore could not have caused a loss. Alternatively, if the cover-up did not succeed, and the market became aware at some time that the accounting statements were incorrect, then proof of the market's awareness and proof of loss caused by such awareness is still required."

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[7] *United States* v. *Olis* (No. 04-20322), pending in the Fifth Circuit, may bear on this issue.

Id. at 870 (quoting *In re Ikon Office Solutions, Inc. Sec. Litig.*, 131 F.Supp.2d 680, 691 (E.D.Pa. 2001)).[8] "In other words," Judge Breyer explained, "the government must prove that the fraud inflated the price of the stock *and* that the investors 'lost' that inflation after the fraud was revealed." *Id.* at 870 (emphasis in the original). In words equally suited to the government's (and Mr. Saunders's) contentions in the present case, Judge Breyer added:

> The government's analysis focuses on the first step – the extent to which the fraud inflated the price of the stock – but does not adequately address the second. Under the government's theory, the loss to investors would be $1.9 million even if the day after the fraud was disclosed the price of Indus shares went *up*. Such a result does not make sense.

Ibid.

Because the government had offered only an artificial inflation measurement of loss, Judge Breyer was constrained to adopt a different approach. Based on the weight of authority, both in the case law and under the securities statutes, Judge Breyer calculated loss by subtracting the average stock price for a defined period *after* the disclosure of the fraud from the average stock price for a defined period *before* the disclosure but *after* the alleged fraud had occurred. He then multiplied that difference by the number of damaged shares as stipulated by the parties. The result, it should be noted, was about *one-sixth* of the artificial inflation figure proffered by the government. *Id*. at 872-73. This method of calculating loss, Judge Breyer explained, was rooted not only in the federal securities laws, but also in "Congress's central purposes in adopting the Guidelines" – to achieve

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[8] In *Ikon*, the plaintiffs – a class of investors in the stock of Ikon Office Solutions – contended that fraud in the company's financial statements caused the stock to trade at artificially high prices, and alleged that the stock price thereafter declined. The district court granted summary judgment in defendant's favor, holding that there was no evidence that the decline in Ikon's stock price was *caused* by any disclosure of the financial statement fraud.

"reasonable uniformity in sentencing," a purpose that would be "thwarted if sentencing courts simply choose a loss figure based on which party's expert is more persuasive." *Id*. at 874.

To our knowledge, every reported criminal case has adopted that same approach to calculating loss in criminal securities cases under the Guidelines. See, *e.g.*, *United States* v. *Snyder*, 291 F.3d 1291, 1296 (11th Cir. 2002) (measuring loss by subtracting the stock price "following announcement of the fraud" from the average stock price for a period of time before the announcement); *United States* v. *Hotte*, No. 98-1684, 1999 WL 642972, at *2 (2d Cir. Aug. 20, 1999) (measuring the loss by subtracting the stock price "after the fraud's disclosure" from the price "during the life of the fraud scheme"); *United States* v. *Brown*, 338 F.Supp.2d 552, 557-59 (M.D. Pa. 2004) (adopting, with some modification, the *government's* recommendation that loss be measured by subtracting stock price after disclosure from stock price before disclosure); *United States* v. *Bakhit*, 218 F.Supp.2d 1232, 1240-42 (C.D.Cal. 2002) (subtracting average selling price after fraud disclosure from average selling price before disclosure).[9]

C. Neither The Probation Office Nor The Government Has Provided This Court With Any Persuasive Reason To Depart From The Overwhelming Weight Of The Case Law

The Probation Office and the government ask this Court to break ranks with the uniform weight of the case law. Their fundamental disagreement with the precedent, however, rests on a fundamental misunderstanding. In their view, if artificial inflation were not used as the measure of actual loss, then "any one investor can transfer *the loss suffered from the artificial inflation* to another unsuspecting investor willing to purchase the stock at the artificially inflated price * * *"

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[9] Effective November 2003, the Guidelines adopted language explicitly instructing courts to consider the "reduction that resulted from the offense in the value of equity securities or other corporate assets." U.S. SENTENCING GUIDELINES MANUAL § 2B1.1, cmt. (n.3(C)(iv)) (2003).

(Gov't Mem. at 15-16 (emphasis added)). See also PSR Addendum at 36 ("the probation office views the selling of inflated stock as a continuing harm, i.e. simply passing the loss on to another victim").

This is a complete canard. Unless and until the inflation leeches out of the stock price, *there has not been any loss at all*. The only consequence of "artificial inflation" is that some number of shareholders own an asset whose theoretical "true value" is less than what its selling price is. But that does not constitute a "loss" within the meaning of any law – the Guidelines, the securities laws, or, for that matter, common law tort principles, from which the federal securities law principles derive. It is not that investors are somehow "transferring the loss suffered" to one another like some hot potato. Until the stock price drops in response to some form of corrective disclosure, there simply is no loss to pass round. The Solicitor General said just that to the United States Supreme Court in *Dura Pharmaceuticals*. See Brief for the United States at 7. Respectfully, the Enron Task Force has no authority to say otherwise.[10]

The government insists, however, that the Guidelines themselves "explicitly tell a court" to use artificial inflation as the measure of loss. Gov't Mem. at 7 (emphasis in the original). See also PSR ¶ 80. In making this bold assertion, the government and the Probation Office invoke, but

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[10] For these reasons, it is the sheerest sophistry to assert, as the government does (Gov't Mem. at 8-9), that an investor suffers an actual loss due to artificial inflation because, had there been no underlying fraud, the investors "would hold the same amount of stock, and have more money in their pockets, and be able to sell the stock at any time with no risk of receiving a reduced sales price because the artificial inflation had dissipated." Gov't Mem. at 9 (emphasis in the original). The investor who buys at the inflated price holds an asset that he can sell the next day at the same allegedly inflated price. After he does so, he will have just as much "money in his pocket" as the investor whom the government hypothesizes. Unless and until the inflation dissipates due to a corrective disclosure, there is no loss, and the mere "risk" of such loss is not the same as an actual loss. (While such a risk may bear on the analysis of "intended loss," there too the government's proof falls short, as we show in Point II).

fundamentally misapprehend, the example presented in Application Note 8(a) to Section 2F1.1. The note states that when a defendant fraudulently misrepresents the value of some stock – by claiming that it is "worth $40,000" when, in truth, it is "worth only $10,000" – "the loss is the amount by which the stock was overvalued (*i.e.*, $30,000)." U.S. SENTENCING GUIDELINES MANUAL § 2F1.1, cmt. (n.8(a)). Read in context, this example *confirms*, not undermines, the principle of loss causation. If, as a result of a corrective disclosure, a security once "worth" $40,000 is now "worth" $30,000 less – and must therefore be sold at a $30,000 loss – then loss causation has been established. Indeed, the very next sentence in the Application Note – which the government omits to quote – illustrates that very point more explicitly. "In a case involving a misrepresentation concerning the quality of a consumer product, the loss is the difference between the amount paid by the victim for the product and the amount for which the victim could resell the product received." *Ibid.* Put another way, if, as a result of the revelation of fraud, an asset that cost 2X on Day 1 can now be sold only for X, the amount of loss is X – whether the asset is securities or toasters. That is nothing more than the doctrine of loss causation.

Nor is it true, as the government misleadingly claims, that the Fifth Circuit's decision in *United States* v. *Deavours*, 219 F.3d 400 (5th Cir. 2000), somehow supports the prosecutors' reliance on artificial inflation as the measure of loss. Gov't Mem. at 16; see also *id.* at 9 (same). *Deavours* simply stated the Fifth Circuit's view that the promoter of a Ponzi scheme typically cannot get credit for loss purposes for the money that he chooses to send to some of his victims. Even that proposition has been repudiated by Amendment 617 to the Guidelines, as the government belatedly acknowledges in its March 24, 2005 letter to the Court. But the case is irrelevant in any event. The *Deavours* Court explained that paying off some of the victims of a Ponzi scheme is the means by

which the scheme remains undetected; a defendant in that setting fully intends all of his victims to run the risk of parting with their entire investment. That principle simply has no bearing on the use of artificial inflation to measure loss, actual or intended, in securities cases, and **no** court has ever said otherwise. To repeat the basic principle: An investor whose stock is "inflated" has **not** – unlike the Ponzi scheme victim – **lost a dime**. And it is especially perverse to pretend otherwise in the present case, since as not even the government can dispute, Enron investors made a huge gain as a result of the Nigerian Barge Transaction. To treat them as if they were victims of a Ponzi scheme is errant nonsense.

It may be, as the PSR adds, that "the sentencing guidelines are focused on sanctioning criminal conduct, rather than seeking damages." PSR Addendum at 36. But insofar as the Guidelines seek to "sanction criminal conduct" by basing incarceration on the amount of loss in a securities matter, the Guidelines adopt the governing case law. There is no reason to make up a new and different "loss" rule for this case.[11]

Perhaps the biggest challenge for the Probation Office and the government is this: **The only pertinent criminal cases adopt and apply loss causation analysis in measuring loss**. Indeed, as

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[11] The Probation Office also asserts that, because the SEC need not prove loss causation when it brings a civil enforcement action, the Merrill Lynch defendants are "over reaching" when they (supposedly) contend that "all civil securities fraud cases require proof of inflation and loss causation." PSR Addendum at 36. That is a strawman. We do *not* contend that "all securities fraud cases" invariably require proof of loss causation. Rather, securities fraud cases require proof of loss causation *when loss is an element*. When the SEC seeks disgorgement, for example, it need not prove loss at all, so it is hardly surprising that it need not prove loss causation either. See *SEC* v. *Fischbach Corp.*, 133 F.3d 170, 175-76 (2d Cir. 1997) ("the measure of disgorgement need not be tied to the losses suffered by defrauded investors, and a district court may order disgorgement regardless of whether the disgorged funds will be paid to such investors as restitution"). But when loss *is* integral to a determination of responsibility – as it manifestly is under U.S.S.G. § 2F1.1 – loss causation is likewise a required part of the proof.

we noted above, Judge Breyer explicitly applied civil case law on loss causation in determining the amount of loss under Section 2F1.1, and he emphatically rejected an artificial inflation argument pressed by one of the same prosecutors who tried this case. To our knowledge, **no** court has ever fallen for that argument.[12]

Bereft of precedent of their own, the Probation Office and the government work hard, but without success, to distinguish the criminal cases we have cited, especially Judge Breyer's decision in *Grabske*. The PSR asserts that *Grabske* sheds no useful light on this case because in *Grabske*, unlike in this case, the fraud was ultimately disclosed to the market and the stock price dropped as a result. PSR Addendum at 37. The Probation Office evidently believes that had Judge Breyer been faced with our facts – where the alleged fraud was *not* publicly disclosed; where in fact the barges were thereafter sold at an enormous profit; and where the company later failed for unrelated reasons – he would have adopted "artificial inflation" as the measure of loss for sentencing purposes. That, however, is demonstrably wrong. As Judge Breyer pointedly explained: "[I]f the fraudulent statements 'were successfully covered up, they were never disclosed to the market and therefore *could not have caused a loss.*'" 260 F. Supp. 2d at 870 (emphasis added). Under such circumstances, Judge Breyer suggested, the government would be unable to sustain its burden to

[12] The PSR quotes a passage from Judge Breyer's decision in which he suggested that, "'given the difficulty in calculating loss in fraud-on-the-market criminal cases, a sentence based on factors other than loss may be more appropriate.'" PSR Addendum at 37 (quoting *Grabske*, 260 F. Supp. 2d at 875). Because the Guidelines nevertheless require a loss analysis, and not some other approach, Judge Breyer based his sentence on loss – and, as we have noted, he flatly rejected the government's "artificial inflation" argument.

"prove that the fraud inflated the price of the stock *and* that the investors 'lost' that inflation after the fraud was revealed." *Id*. at 870 (emphasis in the original).[13]

Perhaps on the premise that the best defense is a good offense, the government asserts that under Judge Breyer's approach, "the amount of loss attributable to defendants is likely much higher than $43.8 million." Gov't Mem. at 22. But that is simply preposterous. Judge Breyer was emphatic that, unless there is evidence that "investors 'lost' th[e] inflation *after the fraud was revealed* (260 F. Supp. 2d at 870 (emphasis added)), there is no loss to be measured. Until they received our initial loss objections, the prosecutors had consistently maintained that the Barge Transaction was *never* publicly disclosed and had *no* role in the collapse of Enron. See Government's Consolidated Response to Defendants' Pretrial Motions at 50 (conceding that "there is no claim" in this case "that the barge deal caused Enron's collapse") (attached as Ex. A). The government's trial expert, Dr. Saunders, could hardly have been clearer on that point himself. Now that it understands the legal consequence of that position, the government asserts "that the disclosures in the fall of 2001 of significant accounting problems at Enron *effectively* revealed the Nigerian barge fraud." Gov't Mem. at 22 (emphasis added). But the loss causation requires an *actual* disclosure to the market, and there wasn't one here. Even the PSR rejects the government's newly-minted contention that the Nigerian Barge Transaction was publicly revealed to be fraudulent

[13] The government chides Judge Breyer for allegedly having "made no attempt to explain why it makes sense to engraft a causation requirement" in this setting. But it is Congress, not Judge Breyer, that "engraft[ed]" the loss causation requirement in the federal securities laws. And it is Congress that likewise approved the Sentencing Commission's "loss" requirement in Section 2F1.1. Judge Breyer explained persuasively and at length why "a causation requirement" is warranted in the determination of loss.

sometime before Enron's demise. See PSR ¶ 82 ("The Nigerian barge fraud was not discovered, until after the stock plummeted *for other reasons*").[14]

D. Under The Governing Legal Standards, There Is No Evidence Of Actual Loss In This Case, And Thus Actual Loss Cannot Be The Basis For Sentencing Under Section 2F1.1

According to the PSR itself – and according to both Saunders and the government at trial – the artificial inflation (if any) in the Enron stock price resulting from the barge deal never left the stock price because the putative fraud was not disclosed prior to the intervention (for other reasons) of Enron's bankruptcy. See PSR ¶ 82 (barge case is more "complex" than the "typical security fraud case, in which the loss to investors was readily discernable by comparing the stock rise, after the significant event, to the stock decline, after the fraud was discovered."). But rather than accept the legal consequences of that concession – that there simply is **no loss caused by the fraud** – the PSR adopts artificial inflation as the measurement of loss.

That is completely unjustified. Although the PSR is surely correct that "loss need not be determined with precision," and that "[t]he court need only make a reasonable estimate of the loss, given the available information" (PSR ¶ 80), a sentencing court is not free to dispense with the element of *causation*. In securities cases, civil and criminal alike, causation requires evidence that the fraud caused the inflation to leech out of the stock. Without such proof, the investors have not

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[14] The government claims (Gov't Mem. at 22) that Judge Breyer's approach would not ordinarily take into account the extent to which a stock drop was attributable to causes *other* than the defendant's fraud. But that is simply not so. The defendant's expert in *Grabske* sought to measure "the incremental effect of the disclosure of the fraud" in the context of additional, confounding information that, taken together, resulted in the stock drop. But the expert "offer[ed] no method" for performing that analysis, so in the end the court was unable to rely on his methodology. Even so, Judge Breyer described the defendant's efforts as "closer to a reasonable amount than the government's figure" – which, as noted, was predicated entirely on an "artificial inflation" theory of loss.

been damaged by the fraud – even if they lose the value of their investment for other reasons (such as Enron's bankruptcy).

Significantly, Professor Fischel pointed out this precise fallacy in Mr. Saunders's argument – yet Saunders offered no rebuttal during his testimony. As Mr. Fischel explained, "Professor Saunders does not contend that the alleged inflation dissipated after the Relevant Period." Fischel Rep. ¶ 18. To the contrary, Fischel noted, Saunders conceded that it was his "'understanding that this transaction and its fraudulent effects on Enron's earnings were not disclosed until after Enron's bankruptcy.'" *Ibid*. (quoting Saunders Rep. at 33). Yet "[i]f the inflation of Enron's share price persisted until after Enron's bankruptcy (when its stock price was essentially zero), then there is no basis for concluding that any portion of investors' losses were attributable to the alleged fraud." *Id*. ¶ 18.

Nor is this some special rule for securities cases. As a general matter, there is "a causation requirement when determining actual loss." *United States* v. *Yeaman*, 194 F.3d 442, 457 (3d Cir. 1999). "Before a court may attribute losses to a defendant's fraudulent conduct, 'there must be some factual basis for the conclusion that th[o]se losses were the result of fraud.'" *United States* v. *Randall*, 157 F.3d 328, 331 (5th Cir. 1998). "In other words, section 2F1.1 is concerned solely with 'the amount of loss *caused by the fraud*.'" *Ibid*. (quoting *United States* v. *Saacks*, 131 F.3d 540, 542 (5th Cir. 1997)). And mere "but for" causation is not sufficient – proof of proximate cause is required. See *United States* v. *Izydore*, 167 F.3d 213, 224 (5th Cir. 1999) (rejecting the government's contention that loss arising from defendant's bankruptcy fraud should include the fees of the bankruptcy trustee; held, "while it is true that the trustee's fees were a consequence of the

appellants' unlawful conduct, mere 'but for' causation is not the litmus test for loss determinations under U.S.S.G. 2F1.1").

United States v. *Hicks*, 217 F.3d 1038 (9th Cir. 2000), illustrates the role of proximate cause in loss determination. There, the defendant contended that the loss sustained by the defrauded bank should not be entirely charged to him because intervening but unrelated misconduct by a foreclosure agent had caused the bank's losses to be greater than they would otherwise have been. The government – again, through one of the prosecutors who tried the present case – told the Ninth Circuit that it need not consider such intervening causes in calculating loss, and that it should instead address those factors in response to a subsequent motion for downward departure. Not so, the court ruled. "That approach is flawed," the court of appeals held, "because it improperly relieves the government of its obligation to prove by a preponderance of the evidence the amount of 'harm that resulted from the acts or omissions' of the defendant. Under the Guidelines, the district court must determine the amount of loss **caused** by the defendant and the resultant Guidelines' sentencing range *before* considering whether to exercise its discretion to depart from that range." *Id*. at 1049 (emphasis added). Because the bank's losses may well have been inflated "by the intervening, independent, and unforeseeable criminal misconduct of the foreclosure agent," the court remanded for a recalculation of loss. *Ibid*.

In the present case, the **only** evidence before the Court is that, if there truly was any artificial inflation in Enron's stock price, it was *not* removed by a disclosure of the fraud. Indeed, as we have noted, whatever artificial inflation may *ever* have been in the stock price was confined to a brief period in early 2000, prior to the eventual barge sale to AES. By late 2000 when the barges were sold, if not sooner, the "inflation" in Enron's stock price was real, not artificial. And in any event,

there was *never* a public disclosure that caused the artificial inflation in Enron's stock price to dissipate. Under those circumstances, the Court has no legal basis for finding **any** actual loss – much less the truly preposterous figure of $43.8 million.

E. The Government's Belated Effort To Satisfy The Loss Causation Standard Is Plainly Insufficient

Having relied at trial *only* on an "artificial inflation" theory of loss, and having sponsored *only* "artificial inflation" testimony through Dr. Saunders, the government now says, at the eleventh hour, that it meets the loss causation standard after all. According to the government, "[t]he Nigerian barge deal was a component of the broader earnings manipulation engaged in by Enron management." Gov't Mem. at 24. By late 2001, the government continues, the public learned that Enron had generally engaged in "fraudulent accounting practices" and "related-party transactions." Gov't Mem. at 24-25. "These and similar events," together with some additional "public disclosures" (not further identified by the government), "revealed to the market that Enron had engaged in wide-spread earnings manipulation, and Enron's stock price plunged as a result." Gov't Mem. at 25. Because the Nigerian Barge Transaction had at least *some* "connection with or relation to" the earnings manipulation engaged in by Enron, the government contends that the loss causation requirement has been satisfied.

That chain of causation would make even Mrs. Palsgraf blush. As the government sees it, it does not matter that there is *no* evidence – none – that the Barge Transaction was ever disclosed to the market and thereby caused a loss of price inflation. All that matters, in the government's mind, is that the Barge Transaction involved "earnings manipulation," and that some *other unrelated* act of "earnings manipulation" actually caused Enron to collapse. On that view, *any* act of alleged "earnings manipulation" – no matter how minuscule, no matter how attenuated in time, and no

matter how factually irrelevant – can be blamed for Enron's demise *so long as some other act also called "earnings manipulation" was the eventual culprit.*

To quote one of the leading securities law jurists of the last fifty years, that is "causation run riot." *Miller* v. *Schweickart*, 413 F. Supp. 1062 (S.D.N.Y. 1976) (Weinfeld, J.). *Miller* presented the loss causation issue in a remarkably similar factual setting. There, certain limited partners of Schweickart, a securities broker-dealer, alleged that Skelly Oil Company had conspired to defraud Schweickart by participating in an illegal "parking" scheme. According to the plaintiffs, Schweickart and Skelly had entered into an agreement, memorialized by written confirmations, by which the broker-dealer would sell certain securities to Skelly. Unbeknownst to the public, however, the parties had entered into an oral "side deal" under which Schweickart would repurchase the securities sometime in the future. The plaintiffs alleged that the reason the repurchase agreement was oral was to enable Schweickart "to avoid the capital restrictions of the New York Stock Exchange." 413 F. Supp. at 1064.

Judge Weinfeld granted summary judgment in the defendants' favor, in part on loss causation grounds. Just like the government in the present case, the plaintiffs in *Miller* contended that Schweickart had engaged in subsequent parking violations that resulted in the company's collapse. 413 F. Supp. at 1067. What is more, the plaintiffs contended, the defendants had concealed their parking violations, and this concealment "'substantially assisted the general partners to continue their "parking" with others,'" thereby contributing to the demise of the company. *Ibid*. Judge Weinfeld found this causation theory entirely "far-fetched." *Ibid*. In words that apply with equal force to the government's newfound loss causation theory in the present case, the district court explained:

> To accept plaintiffs' theory would extend liability for fraud beyond the immediate and foreseeable consequences of one's wrongdoing and in effect make Skelly the permanent accomplice of the Schweickart general partners in all their subsequent parking transactions with others; it would subject Skelly to strict liability for any future depredations by those general partners long after Skelly had ceased to have any dealings with Schweickart, even for deeds done with others years later, of which Skelly had no knowledge. This is causation run riot.

Id. at 1068.

Here, too, the government argues in substance that the Merrill Lynch defendants, by engaging in an alleged "parking" transaction, and by helping Enron to engage in alleged "earnings manipulation," thereby became "permanent accomplice[s]" with Enron in any future "parking" transactions and efforts to manipulate earnings. But loss causation cannot be established at that extraordinarily high level of generality. To claim otherwise, as Judge Weinfeld put it, is truly a "far-fetched theory of causation." *Id.* at 1067.

Even if the Court were otherwise disposed to embrace a theory like this, it cannot do so on the present record. The government has the burden to *prove* the loss, not just assert it. And to discharge that burden, it will not do to argue, as the government does, that the Court should simply "resolve the question based on its independent review of the facts." Gov't Mem. at 26 n.9. What facts? The "fact" that the Nigerian Barge Transaction somehow was publicly disclosed and caused a stock drop? The "fact" that some particular amount of artificial inflation dissipated in the wake of the putative disclosure? The "fact" that some number of shareholders lost money as a result? If so, how many, and how much did each of them lose? These are not matters about which a court can simply take judicial notice. They are matters of *proof*, and the government – having labored for so long under the erroneous impression that loss causation was irrelevant – never offered any.

F. It Is Particularly Inappropriate To Make A Loss Finding In This Case, Because Enron's Shareholders Indisputably Profited From The Nigerian Barge Transaction

The Nigerian Barge Transaction was, without question, a tremendous success story for Enron and its shareholders. In the latter part of 2000, following the LJM2 purchase of Merrill Lynch's ownership position, Enron arranged for the sale to AES of nine barges – including the three in which Merrill Lynch had been a passive investor – for a total of $126 million. Less its initial investment of about $72 million, Enron thereby obtained a profit from the AES sale of $53 million. Brown Ex. 638.

In light of that outcome, it makes absolutely no sense to impose jail time on the defendants based on the counter-factual premise that Enron shareholders *lost* money on the Barge Transaction. As noted, the transaction with Merrill Lynch simply had the effect of allowing Enron to book a gain (albeit improperly, in the government's view) too early. But the gain, though too early, was not fictitious – and Enron's shareholders ultimately profited handsomely. It belies reality to send the defendants to jail on the premise that Enron and its investors suffered a loss.[15]

The government misunderstands this fundamental point when it argues that "[t]he fact that the barges themselves turned out to be profitable for Enron has no bearing whatsoever on the conduct of the defendants." Gov't Mem. at 32. But our argument that "the barges * * * turned out to be profitable" is addressed, not (as the government suggests) to "the conduct of the defendants,"

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[15] As if to bathe their extraordinarily harsh recommendation in the glow of leniency, the prosecutors contend that they are "only" seeking "to hold defendants responsible for the $.47 per share of artificial inflation directly caused by defendants' offense conduct." Gov't Mem. at 18 n.6. **But there is no evidence that a single one of the Enron investors actually *lost* the purported $.47 per share**. To the contrary, because the Barge Transaction was a huge success for the company, Enron's investors profited handsomely from the deal. The government's insistence that investors actually *lost* $.47 per share because of the Barge Transaction is entirely without support in the record.

but to the quite distinct question of *loss*. And our point is simple yet fundamental: There was no actual loss to Enron shareholders on account of the Barge Transaction. Which leaves the government with this basic conundrum: Why should the defendants be sent to jail based on *loss* when the company and its shareholders sustained nothing but *gain*?

II. MR. SAUNDERS'S ANALYSIS ALSO FAILS AS THE MEASURE OF "INTENDED" LOSS IN THIS CASE

The PSR implicitly recognizes that Professor Saunders's analysis cannot serve as the basis for an "actual" loss finding. That is doubtless why the report uses Saunders's $43.8 million figure as a proxy for "intended" loss, not actual loss. But Mr. Saunders's analysis is no more persuasive when labeled "Intended Loss" instead of "Actual Loss."

It must be said at the outset that there is no authority for shifting the ground of this case from "actual" to "intended" loss. Mr. Saunders himself was quite explicit that his analysis was directed only to the issue of *actual* loss. See Saunders Rep. 24. Now that actual loss has evaporated as an available legal theory, it would contradict all applicable legal authority and violate due process to sentence defendants to years in prison for an "intended" loss.

But even if it were appropriate to introduce "intended loss" at this juncture, there is no proof in the record that the Merrill Lynch defendants intended a loss in this case. The most that might be said of the government's proof is that it shows that the defendants intended that the price of Enron's stock would be inflated for a brief period of time until the *real earnings* associated with the sale to AES were realized. As we have already shown, such artificial inflation does not constitute loss, and thus cannot establish that the Merrill Lynch defendants intended that anyone actually suffer loss. In fact, the evidence powerfully supports the *opposite* inference – that the Merrill Lynch defendants expected that Enron would eventually sell the barges for a profit in 2000, and that Enron's

shareholders would benefit enormously. And as events unfolded, these expectations were entirely borne out. On this record, there simply is no basis for finding an intended loss – much less the preposterous figure of $43.8 million.

A. To Prove "Intended Loss" In This Case, The Government Had To Establish That The Defendants Actually Intended To Cause A Loss To Enron Or Its Shareholders

The Fifth Circuit has squarely held that the concept of "intended loss" under Section 2F1.1 "refer[s] to actual intent, not constructive intent." *United States* v. *Henderson*, 19 F.3d 917, 928 (5th Cir. 1994). "[O]ur case law requires the government prove by a preponderance of the evidence that the defendant had the subjective intent to cause the loss that is used to calculate his offense level." *United States* v. *Sanders*, 343 F.3d 511, 527 (5th Cir. 2003). Courts must therefore determine what the defendants actually intended the loss (if any) to be. They are not free to imagine what losses were conceivable and then "construct" that figure as if it were what the defendants "intended" the loss to be. Nor may courts simply presume that defendants intend the results of the actions they took – indeed, *Henderson* specifically rejected that interpretation. 19 F.3d at 928.

Henderson illustrates just how seriously this Circuit takes these principles. The defendant in *Henderson* was convicted of bank fraud for failing to disclose material information in loan applications. *Id.* at 920-22. The district court, misapprehending the governing law, found that the "intended loss" was the full value of the fraudulently obtained loans. *Id.* at 927. Reversing, the Fifth Circuit noted that, under Section 2F1.1, intended loss must be based on facts that show the loss the "*defendant was attempting to inflict*." *Id.* at 928 (quoting U.S. SENTENCING GUIDELINES MANUAL § 2F1.1, cmt. (n.7) (1994)) (emphasis added by Fifth Circuit). Accordingly, the court held, "where the defendant intends to repay the [fraudulently obtained] loan or replace the [stolen] property, the intended loss is zero." *Id.* at 928. The court concluded that "[t]he district court must

determine if [the defendant] *actually intended* to cause a loss . . . and, if so, the amount of the intended loss." *Ibid.* (emphasis added).

B. Even If The Government Proved That The Defendants Intended To Inflate The Value Of Enron Stock, That Is Not Nearly Enough To Constitute An "Intended Loss"

The government did not and cannot meet its burden of proof to show that the defendants "actually intended" to cause a loss to Enron shareholders *at all* – much less the extraordinary $43.8 million loss recommended in the PSR. See *Henderson*, 19 F.3d at 928. Even if the government had proved that the defendants sought to cause an inflation in Enron's 1999 stock price by enabling the company to book $12 million of income on its 1999 financial statements instead of its 2000 financial statements, that would be insufficient.[16] For the reasons explained in Point I, artificial inflation does not prove intended loss unless the Merrill Lynch defendants *also* intended to cause the inflation to dissipate in the wake of a corrective disclosure.[17] The defendants harbored no such intent, nor did the government prove otherwise.

Indeed, the notion that the Merrill Lynch defendants intended Enron's shareholders to sustain a *loss* is fundamentally inconsistent with the very theory of this prosecution. According to the

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[16] We do not concede that the government proved intent even on this issue. The jury made no specific finding in this regard, nor did the instructions require it to do so. And there was compelling evidence at trial that the Merrill Lynch defendants did **not** believe that the Barge Transaction would have any material impact on Enron shareholders. As Katherine Zrike, Chief Legal Counsel of Merrill Lynch's Investment Banking Division, testified, the Debt Markets Commitment Committee ("DMCC") concluded that the one penny in earnings was not material; she in turn communicated that point to Dan Bayly; and Bayly and his superior, Tom Davis, discussed the point as well. Tr. 4097, 4124.

[17] It is therefore beside the point to say, as the PSR does, that "the defendants could only have believed" that their conduct "would inflate the stock value, not deflate it." PSR Addendum at 25. Because artificial inflation *is not a loss*, an intent to "inflate the stock value," even if proved, would not constitute an intended *loss*.

Indictment, Enron promised Merrill Lynch that it would find a third-party buyer for the barges within six months. Only if those efforts failed would Enron allegedly repurchase the barges itself. Indictment ¶ 13. Merrill Lynch's role, under that theory, was – as GX-209 put it – to serve "as a bridge to permanent equity."

Even if Merrill Lynch, by performing that role, enabled Enron to recognize earnings too early – in 1999, rather than in 2000 – the earnings were nevertheless *real*, not fake. As noted above, in the latter part of 2000, following the LJM2 purchase of Merrill Lynch's ownership position, Enron arranged for the sale to AES of nine barges – including the three in which Merrill Lynch had been a passive investor – for a total of $126 million. Less its initial investment of about $72 million, Enron thereby obtained a profit from the AES sale of $53 million. Brown Ex. 638. This was, in short, a case about an *accelerated gain*, not an intended loss. There is absolutely no evidence – none – that the Merrill Lynch defendants intended anything else.

The government thus completely misses the mark when it cites (Gov't Mem. at 26-31) a line of cases involving defendants who procured, or assisted in procuring, sums of money from unsuspecting lenders (typically banks, but sometimes private investors) based on fraudulent representations. See, *e.g.*, *United States* v. *Morrow*, 177 F.3d 272, 300-01 (5th Cir. 1999) (where defendant mobile home sellers arranged for mobile home purchasers to obtain bank financing on fraudulent bases, and were "'consciously indifferent or reckless'" as to how much money the bank would lose, the intended loss was the full face amount of the loans); *United States* v. *Tedder*, 81 F.3d 549, 550-51 (5th Cir. 1996) (where defendant credit counselor provided false social security numbers and other advice to enable persons with "poor credit" histories to obtain bank loans, and was in no position to affect the extent of the bank's losses, he was chargeable with the full face

amount of the loans applied for); *United States* v. *Hill*, 42 F.3d 914, 918-19 (5th Cir. 1995) (where defendant "rented out" bogus securities with a face value of $69 million, and permitted companies to pledge those "assets" as security for loans, the intended loss was the full amount that the unsuspecting lenders might have lent); *United States* v. *Dahlstrom*, 180 F.3d 677, 685 (5th Cir. 1999) (where defendant founder and CEO of company raised $1,997,003 from private investors on the strength of false claims about the commercial viability of his company's sole product, the intended loss was the full amount of money he obtained from his victims). In these cases, the defendants clearly intended to enrich themselves or their customers at the expense of the victims of their fraud, and the only question was whether the defendants should be credited for the mere possibility that *some* of the fraudulently obtained money might be repaid. The courts sensibly held that, where a defendant intends to take money or property unlawfully, and is essentially indifferent (or unable to affect) the full *extent* of the reasonably foreseeable losses he sets in motion, he is chargeable with "the amount that [he] placed at risk by misappropriating [the] money or other property." *United States* v. *Deavours*, 219 F.3d 400, 403 (5th Cir. 2000).

The present case is the polar opposite. The Merrill Lynch defendants intended Enron and its shareholders to gain, not lose, both in the near and long term. They didn't take or receive a penny from the putative victims, nor did Enron's shareholders part with a penny. There is no evidence to the contrary. On facts like these, the Fifth Circuit has invariably refused to find intended loss. See *Sanders*, 343 F.3d at 527 (where the government failed to prove that the defendant did not intend to repay the loan, only the "actual loss" occasioned by a bank fraud could be used under Section 2F1.1); *United States* v. *Sublett*, 124 F.3d 693, 695 (5th Cir. 1997) (vacating and remanding a sentence where there was "no basis" in the record for an inference that the defendant "actually * *

* intended" to cause the loss found by the district court); *United States* v. *Quaye*, 57 F.3d 447, 448-49 (5th Cir. 1995) (vacating and remanding sentence where district court did not make finding whether defendant intended to repay loans).

In short, when "intended loss" is assessed – as it must be – according to the defendants' "actual intent," there is no factual basis in this case to make *any* intended loss finding. But even if the Court were to conclude that the defendants did intend to cause *some* loss to Enron shareholders, there simply is no *non-speculative* basis on which to infer the amount of that intended loss. As the commentary to Section 2F1.1 expressly states, only "if an intended loss that the defendant was attempting to inflict *can be determined*," may a court invoke intended loss as a substitute for actual loss. U.S. SENTENCING GUIDELINES MANUAL § 2F1.1, cmt. (n.8(a)). Accord, *Sanders*, 343 F.3d at 522 (an "intended loss" must be "capable of being determined"). To treat Saunders's figure as the intended loss is unvarnished guesswork – nowhere close even to a "reasonable approximation." Saunders himself did not suggest that his figures reflected what the defendants "actually intended."

Moreover, to use Saunders's "artificial inflation" construct in that fashion would completely circumvent the requirement of loss causation. If, as the PSR suggests, "intended loss" were a permissible means of avoiding all the rules about calculating "actual loss" in securities cases, one would not expect to see courts in criminal cases grappling with the difficulties of determining actual loss. After all, the commentary to Section 2F1.1 states that intended loss should be used "if [this figure] is greater than the actual loss." Yet in each and every one of the criminal cases surveyed above involving loss to shareholders of publicly-traded companies, the courts have sought to calculate *actual* loss (along the lines we noted in Point I). See, *e.g.*, *Grabske*, 260 F.Supp.2d at 870 (calculating actual loss and expressly rejecting artificial inflation as measure of such loss); *Snyder*,

291 F.3d at 1296 (calculating actual loss); *Hotte*, 189 F.3d 462 (same); *Brown*, 338 F.Supp.2d at 557-59 (same); *Bakhit*, 218 F.Supp.2d at 1240-42 (same).[18] And the rule of lenity reinforces the conclusion that the Guidelines should be construed *not* to jettison the requirement of loss causation. See *United States* v. *R.L.C.*, 503 U.S. 291, 305 (1992) (the "rule [of lenity] has been applied not only to resolve issues about the substantive scope of criminal statutes, but to answer questions about the severity of sentencing").

Under the case law, the Court simply has no non-speculative basis for making a finding on intended loss. See *United States* v. *Peterson*, 101 F.3d 375, 384 (5th Cir. 1996) (calculating loss in securities fraud case as amount that defendant specifically promised investors, less amount they actually received, without speculating as to possible loss caused by defendant's fraudulent omissions). It should not use intended loss as a basis for sentencing.

C. If The Court Nevertheless Adopts $43.8 Million As The Measure Of "Intended Loss," It Should Grant A Downward Departure (Or Impose A Non-Guidelines Sentence) Because Such An "Intended Loss" Bears No Rational Relationship To The "Actual Loss" (Which Was Zero)

For the reasons stated above, the government has failed to prove that the Merrill Lynch defendants intended *any* loss in this case; the evidence proves just the opposite. If the Court nevertheless adopts the government's recommendation in this respect, it should grant a downward

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[18] The government claims to have located two criminal securities cases – each involving what the government describes, with considerable understatement, as "somewhat different facts" (Gov't Mem. at 31 n.12) – in which intended loss was used to measure loss. In the first of these, *United States* v. *Manas*, 272 F.3d 159 (2d Cir. 2001), the court actually used "intended gain" as the measure of loss; what is more, the defendants expressly conceded the permissibility of that methodology – which is crucial, because the Guidelines themselves do not even set forth an "intended gain" standard. *Id*. at 165. In the second case, *United States* v. *Graye*, No. 02 CR. 336, 2003 WL 282195 (S.D.N.Y. Feb. 10, 2003), there is no indication that loss was even a litigated issue.

departure to eliminate any adjustment on account of loss, or impose a non-Guidelines sentence under the criteria set forth in *United States* v. *Mares*, No. 03-21035 (5th Cir., March 4, 2005). As the Guidelines make clear, "[w]here the loss determined * * * significantly * * * overstates the seriousness of the defendant's conduct, a[] * * * downward departure may be warranted." U.S. SENTENCING GUIDELINES MANUAL § 2F1.1, cmt. (n.8(b)). Similarly, under *Mares*, a non-Guidelines sentence is warranted, even if the Court were to determine that a Guidelines "departure" is not justified. See *Mares*, slip op. 15-16. Here, the "actual loss" to Enron and its shareholders was zero. The putative "victims" in fact secured a handsome gain.

Under those circumstances – where there is *no* actual loss at all, and where the evidence of "intended loss" rests on a loose amalgam of dubious economics and an even more dubious command of basic loss causation principles – it defies common sense, and affronts any notion of justice, to impose an adjustment on account of "intended loss." Whether the Court simply rejects "intended loss" outright, or reaches the same result through a downward adjustment, the result should be the same: There should be no adjustment on account of intended loss.

III. UNDER THESE CIRCUMSTANCES – WHERE THERE IS NO REASONABLE BASIS FOR FINDING *EITHER* AN ACTUAL OR INTENDED LOSS, AND WHERE ENRON SHAREHOLDERS PROFITED FROM THE BARGE TRANSACTION – THERE SHOULD NOT BE ANY LOSS ADJUSTMENT, EVEN ONE BASED ON GAIN

In these circumstances – where there is no provable loss and indeed a probable gain to the putative victims of the Barge Transaction – there is no legal basis for imposing any adjustment for loss to the putative victims or gain to the defendants. Although the Fifth Circuit held in *United States* v. *Haas*, 171 F.3d 259, 270 (5th Cir. 1999), that "if the loss is either incalculable or zero, the district court must determine the Section 2F1.1 sentence enhancement by estimating the gain to the

defendant as a result of his fraud," the Sentencing Commission thereafter rejected the Fifth Circuit's position. Pursuant to Amendment 617 to the 2001 Sentencing Guidelines, "[t]he court shall use the gain that resulted from the offense as an alternative measure of loss *only if there is a loss* but it cannot reasonably be determined." U.S. SENTENCING GUIDELINES MANUAL § 2B1.1, cmt. (n.1) (2001) (emphasis added).

To be sure, it is the 2000 version of the Sentencing Guidelines that is generally applicable to the question of loss in this case. Nevertheless, "the court shall consider subsequent amendments, to the extent that such amendments are clarifying rather than substantive changes." U.S. SENTENCING GUIDELINES MANUAL § 1B1.11(2); see also *United States* v. *Anderson*, 5 F.3d 795, 802 (5th Cir. 1993). The Fifth Circuit has adhered to this rule, explaining that "[a]lthough [such an] amendment is not controlling, [the court] consider[s] it as evidence of the Sentencing Commission's intent." *Anderson*, 5 F.3d at 802; see, *e.g.*, *United States* v. *Gross*, 26 F.3d 552, 555 (5th Cir. 1994); *United States* v. *Maseratti*, 1 F.3d 330, 340 (5th Cir. 1993); *United States* v. *Evbuomwan*, 992 F.2d 70, 73-74 (5th Cir. 1993); *United States* v. *Nissen*, 928 F.2d 690, 694-95 (5th Cir. 1991); *United States* v. *Aguilera-Zapata*, 901 F.2d 1209, 1213-14 (5th Cir. 1990).

In this case, Amendment 617 is plainly a clarifying amendment. The Commission itself stated that the amendment "*clarifies* that there must be a loss for gain to be considered." U.S. SENTENCING GUIDELINES MANUAL, app. C (2001) (emphasis added). And this Circuit has consistently deferred to the Commission's characterization of its amendments.[19] Accordingly,

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[19] See, *e.g.*, *Aguilera-Zapata*, 901 F.2d at 1213 (considering subsequent amendment where the stated purpose of the amendment "is to *clarify* the guideline and commentary"); *Gross*, 26 F.3d at 555 n.12 (considering subsequent amendment where the amendment "clarifies the operation of this section to resolve a split among the courts of appeal"); *Maseratti*, 1 F.3d at 340 (considering subsequent amendment that "'clarifies and more fully illustrates the operation of this guideline'");

because there is no basis for finding any kind of loss in the present case, there cannot be an adjustment based on gain.

IV. THE ALTERNATIVE LOSS AMOUNTS SUGGESTED BY THE PSR AND THE GOVERNMENT ARE MISTAKEN

A. The PSR's $12 Million Loss Alternative

The PSR suggests, as the first in a series of alternatives, that a calculation of loss might be based on the "12 million in falsified revenue on the financial statement." PSR Addendum at 38. Under the government's theory, however, this $12 million was the *gain*, not *loss*, to Enron. We are unaware of any case in which the **gain** to the putative victim of the crime is treated as a proxy for the **loss** to the same victim.[20]

B. The PSR's $1,475,000 Loss Alternative

The PSR next suggests that the Court might choose $1,475,000 as the amount of loss. PSR Addendum at 38. But this figure, too, is indefensible, since, among other things, it impermissibly attributes to the Merrill Lynch defendants the $700,000 that LJM2 received once the barges were sold to AES. There is absolutely no evidence – none – that the Merrill Lynch defendants were responsible for LJM2's decision in late 2000 to sell its interest in the barges to a third party. Indeed,

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cf. *United States* v. *McIntosh*, 280 F.3d 479, 485 (5th Cir. 2002) (holding Amendment 634 to be substantive where "the commentary to Amendment 634 does *not* state it is intended to clarify"); *United States* v. *Caldwell*, 302 F.3d 399, 419 & n.17 (5th Cir. 2002) (holding Amendment 617's commentary regarding the deduction from loss of value for services rendered to be a substantive change where the commentary described the provision as "codifi[ng]" an "adopted" approach that is "better" suited for determining the seriousness of the offense and the culpability of the defendant).

[20] Although the PSR quotes from Judge Breyer's decision in *Grabske* in support of this alternative, it overlooks the fact that Judge Breyer was musing about ways of sentencing "based on factors *other* than loss." 260 F. Supp. 2d at 875 (emphasis added). When Judge Breyer imposed the actual sentence, however, he did so based on loss.

the government itself states in its Memorandum in Aid of Sentencing (at 31) that "the sale of the barges to AES had absolutely nothing to do with the fraudulent transactions between Enron, Merrill Lynch, and LJM2." What is more, there is no basis for asserting that $350,000 of the total payment to LJM2 – paid *by AES* – was somehow a loss *to Enron*.

C. The Government's $775,000 Loss Alternative

Of all the theories of loss, the only one that finds at least *some* foundation in the record is its alternative suggestion based on the $775,000 in fees paid to Merrill Lynch. Tr. 417-18. Here, again, however, we do not believe that the government has sustained its burden of proof.

First, the fees paid by Enron would have to be discounted by the investment value – to Enron – of six months' access to the $7 million paid by Merrill Lynch. At any appropriate rate of return, that would reduce the net fees paid by Enron well below $500,000 (assuming that such fees are an appropriate measurement of loss at all).[21]

But even that figure significantly overstates Enron's actual loss on account of fees paid. Enron, after all, paid only the first $250,000 of the $775,000, with LJM2 paying the balance. If the $250,000 is used instead of the $775,000, and is then offset by the value to Enron of the use of $7

[21] Although the PSR declines to apply this discount (Addendum at 37), it offers absolutely no rationale for that judgment. All the PSR says is that the Probation Office "is not persuaded * * * that the Sentencing Commission envisioned" such a reduction. PSR Addendum at 37. But why? It is the *loss to Enron*, after all, that we are trying to measure. If, in return for its payment to Merrill Lynch, Enron received a $7 million payment and got to keep that money for half a year, surely the loss to Enron, whether actual or intended, should take account of what Enron received. That is precisely how the Guidelines are generally designed to operate. See, *e.g.*, U.S. SENTENCING GUIDELINES MANUAL § 2F1.1, cmt. (n.8(b)) (measure of loss to bank in a fraudulent loan application case must be "reduced by the amount the lending institution has recovered (or can expect to recover) from any assets pledged to secure the loan").

million for six months, the net fees are zero. Moreover, as we demonstrated above, Enron did not sustain a loss at all, but rather obtained a $53 million gain, on the Barge Transaction.

The only other plausible basis for calculating a loss was presented by Professor Fischel at the sentencing hearing. Although Fischel was not convinced that the Barge Transaction caused any loss at all (see Fischel Rep. ¶¶ 18, 29-30), he offered one way of determining the *greatest* loss that *might* have been sustained by Enron's shareholders, based on an undisclosed imputed "put" option. The most that put may have been worth was about $126,529. *Id*. ¶ 29 & n.13. Although the PSR rejects Fischel's analysis, its reasons for doing so are wholly unpersuasive.[22]

CONCLUSION

For the foregoing reasons, defendants Daniel Bayly, James A. Brown, William R. Fuhs, and Robert S. Furst oppose any adjustment in the Guidelines calculation based on loss.

DATED this 25th day of March, 2005.

[22] For example, there is no basis for inferring, as the PSR does, that Merrill Lynch did not pay Enron "a fee to retain the right to 'put' the barges back." PSR ¶ 78. As Mr. Fischel explained at trial, Merrill Lynch paid Enron $7 million for its participation in the Barge Transaction, and the PSR offers no basis for its assumption that this payment failed to take implicit account of the value of the imputed put. See Tr. 6788. Nor is it true that "Fischel's analysis does not factor the effect on Enron's stock price, had Enron not met its projected earnings." PSR ¶ 78. See Fischel Rep. ¶ 27. We also note that – contrary to the PSR's claim (at ¶ 79) – it manifestly is **not** "undisputed that had Enron not booked a $12.563 million before tax gain, it would have missed its earnings by one cent." Indeed, the evidence at trial showed that the last consensus estimate for Enron fourth quarter earnings was 30¢ – which Enron would have hit **without** any contribution from the Barge Transaction. Tr. 3537-38.

Respectfully submitted,

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The undersigned hereby certifies that a true and complete copy of the foregoing document was served via overnight delivery on counsel for defendants and the government's counsel of record at the following address this __ day of March, 2005.

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