Rethinking Sentencing Guidelines in Criminal Securities Frauds

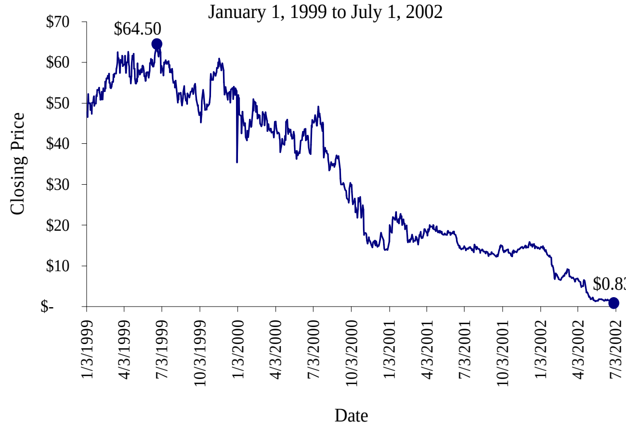
In a Manhattan courtroom last week, Bernie Ebbers, former CEO of WorldCom, was sentenced to 25 years in prison. On March 15, Mr. Ebbers had been found guilty of causing false financial reports to be filed with the Securities and Exchange Commission from the third quarter of 2000 through the first quarter of 2002. The market first learned that WorldCom's profits were inflated through a company press release in June 2002.

Investors lost billions of dollars in WorldCom securities – and tragically some investors lost literally their entire life savings. In addition, as WorldCom declined after the fall of 1999 tens of thousands of employees were laid off. But public outrage over these tragic losses and the clamor for retribution do not justify the prison sentence received by Mr. Ebbers.

Investors lost billions of dollars in WorldCom securities because of the deteriorating telecommunications industry and the business strategies pursued at WorldCom. These market conditions and legitimate business judgments, and not the actions for which Mr. Ebbers was convicted, had already caused WorldCom's split-adjusted stock price to decline by 98.7% from its $64.50 peak on June 21, 1999 to $0.83 on June 25, 2002 before the accounting restatements were announced. That is, even if the false statements Mr. Ebbers was convicted of making were true 99% of the losses from WorldCom's peak stock price would have occurred. *See* Figure 1.

The same factors which caused WorldCom's stock price to fall from $64.50 to $0.83 caused the stock price to fall after the June 25, 2002 announcement and ultimately led to the WorldCom's bankruptcy filing. Mr. Ebbers' illegal actions may have delayed investors' realization that WorldCom's business model had failed but unlike defendants in other recent high-profile criminal securities frauds, Mr. Ebbers was not convicted of looting WorldCom.

Figure 1
WorldCom's Adjusted Closing Stock Price
January 1, 1999 to July 1, 2002



There was no evidence that the actions for which Mr. Ebbers was convicted reduced WorldCom's assets or earnings in the summer of 2002 from what they would have otherwise been. Given this, it is hard to fathom Mr. Ebbers' extraordinary sentence. Unfortunately, Mr. Ebbers' sentence is the predictable outcome of the flawed federal sentencing guidelines combined with the low burden required of the government in proving the size and cause of losses at sentencing hearings.

Under the guidelines, a recommended sentence range is determined based mainly on how much money investors lost as a result of the conduct for which the defendant was found guilty. As we saw earlier, WorldCom's stock price had declined to $0.83 before the accounting restatements were disclosed. Judge Jones ruled in Mr. Ebbers' case that the loss suffered by an institutional investor in WorldCom stock after the restatement announcement was a reasonable lower bound on the losses due Mr. Ebbers' actions. There was no evidence concerning what part

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of the institutional investor's losses in WorldCom was attributable to the disclosure of the accounting restatements versus the other bad news simultaneously reaching investors.

A crude calculation like the one performed by Judge Jones would not be admissible in securities class action litigation because the calculation does not distinguish between losses resulting from fraud and losses resulting from legitimate investment risks. For decades, in order to recover, plaintiffs in securities class action lawsuits have had to prove the losses they suffered were caused by the alleged fraud. This is only common sense and simple justice. Companies that could show that the losses resulted from factors other than the fraud – general industry declines, for example – were not held liable.

Ironically, in criminal cases where a person's liberty is at stake, prosecutors need not establish the amount of losses with the same degree of certainty or logic that plaintiffs suing for money damages based on those losses must demonstrate. As a result losses which are not caused by the defendant's fraud - or even by fraud at all - are used to sentence defendants. Criminal defendants fighting for their liberty should be given the same defenses corporations and individuals defending their pocketbooks are afforded.

As bad as the sentencing guidelines and standards for evidence are at sentencing hearings, they are much worse when applied to executives like Mr. Ebbers. The same loss thresholds are used for all sorts of property offenses and are therefore much too low for frauds involving large publicly traded companies; the guidelines' maximum recommended sentence range – essentially a life sentence for most defendants – is easily reached as a result of market declines experienced routinely by companies where no fraud has occurred.

The highest loss threshold under the guidelines applicable to Mr. Ebbers was only $100 million. On every single day in 2000, the market value of at least a dozen S&P 500 companies fell by more than $100 million. Moreover, 27% of the daily changes in market values of the S&P 500 companies in 2000 were losses greater than $100 million. This means that if you randomly pick an S&P 500 company and randomly pick a date in 2000, there is a greater than 1 in 4 chance that the company's market capitalization fell more than $100 million that day. These declines were the result of the arrival of new information and the ebb and flow of investor sentiment – not the result of fraud and so should not be used to justify long prison sentences.

In securities class actions, plaintiffs must show that the company's stock price decreased by a statistically meaningful amount when the fraud was disclosed and that the decrease was not the result of the disclosure of non-fraud related information. To be meaningful at the statistical level typically applied, the market capitalization of an S&P 500 company would have had to drop more than $1 billion in a single day in 2000 in response to an alleged disclosure of a fraud. Thus, the threshold prosecutors must show to justify a life sentence in a criminal case is less than 10% of what securities class action plaintiffs must show to prove that the alleged fraud had *any* impact on the value of their investments before they can recover a single dollar.

Despite a recent Supreme Court decision which made the federal sentencing guidelines advisory rather than mandatory, their continued application in criminal securities fraud sentencing leads to unjust sentences like the sentence received by Mr. Ebbers. The sentencing guidelines for criminal securities fraud should be scrapped or thoroughly overhauled to make sentences more equitable.

At a minimum, the federal sentencing guidelines should be reformed to require that the government prove that investors suffered losses as a direct consequence of the alleged fraud to the same degree of certainty, and with the same sort of scientific validity, as is currently required in civil litigation. Government attorneys object that meeting the same evidentiary burden civil plaintiffs must meet would be too burdensome but it is a price we should pay before sentencing another executive to an unjust life sentence.

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