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SECOND CIRCUIT REVIEW

Expert Analysis

Narrowing the Bounds of 'Windfall' Restitution Awards in Financial Fraud Cases

By **Martin Flumenbaum** And **Brad S. Karp**

In *United States v. Calderon*, No. 17-1956 (2d Cir. Dec. 3, 2019), the U.S. Court of Appeals for the Second Circuit limited the availability of "windfall" restitution awards and narrowed its interpretation of the "proximate cause" requirement for financial fraud victims under the Mandatory Victims Restitution Act of 1996 (the MVRA), 18 U.S.C. §3663A. In an opinion written by Circuit Judge Debra Ann Livingston, and joined by Circuit Judges Amalya Kearse and Rosemary Pooler, the Second Circuit ruled that the MVRA "does not supply a windfall for those who independently enter into risky financial enterprises through no fault of the fraudsters," where the financial loss at issue was not proximately caused by the defendant's criminally fraudulent conduct.

Background

Defendants Pablo Calderon and Brett Lillemoe structured third-party transactions in the USDA's Export Credit Guarantee program (GSM-102). Designed to "increase exports of agricultural commodities," the GSM-102 program guarantees loans made by U.S. banks to foreign banks in connection with U.S. commodity exports to developing nations. 7 U.S.C. §5622(b)(1). Acting as GSM-102 financial intermediaries, the defendants facilitated foreign bank participation in the GSM-102 program by: (i) arranging a letter of credit between the foreign bank and a U.S. bank, and (ii) presenting certain compliant documents to U.S. banks in order for the U.S. bank to finance the USDA-guaranteed export transaction. The banks paid defendants fees for this service.

In return for a U.S. bank's participation in the GSM-102 program, the USDA guarantees the foreign bank's repayment, generally covering 98% of the foreign bank's obligation under the letter of credit. A letter of credit, thus, reduces the risk of nonpayment by foreign banks. Following the 2007 global financial crises, International Industrial Bank of Russia (IIB)—USDA-approved foreign bank that had issued several letters of credit for the defendant—collapsed and defaulted on over $18 million in GSM-102 obligations to U.S. banks CoBank and Deutsche Bank. Honoring its guarantees, the USDA reimbursed the banks 98% of the unpaid principal.

District Court Proceedings

The Justice Department investigated IIB's collapse and found that, from 2007 to 2012, defendants had conspired to fraudulently obtain millions of dollars in loans by falsifying bills of lading and presenting the falsified shipping documents to CoBank and Deutsche Bank (the "defrauded banks") to facilitate the release of millions of dollars in USDA-guaranteed loans to foreign banks. Defendants were indicted for conspiracy to commit wire and bank fraud, and on multiple counts of wire and bank fraud, among other charges.

A jury convicted defendants of one count of conspiracy to commit wire fraud and bank fraud, in violation of 18 U.S.C. §1349. Calderon was also

MARTIN FLUMENBAUM *and* BRAD S. KARP *are litigation partners at Paul, Weiss, Rifkind, Wharton & Garrison, specializing in complex commercial and white-collar defense litigation. Brad is the Chairman of Paul, Weiss.* NAIRUBY L. BECKLES, *a litigation associate at the firm, assisted in the preparation of this column.*

convicted of one count of wire fraud, in violation of 18 U.S.C. §1343, and sentenced to five months' imprisonment. Lillemoe was convicted of an additional four counts of wire fraud, in violation of 18 U.S.C. §1343, and sentenced to fifteen months' imprisonment followed by three years of supervised release.

The district court entered restitution orders as to both defendants, relying on two provisions of the MVRA. *First*, relying on §3664(j)(1) of the MVRA, the district court held that the USDA was entitled to an order of restitution of $18.5 million after reimbursing the defrauded banks for IIB's defaulted GSM-102 program obligations involving defendants. *Second*, pursuant to §3663A(b)(4) of the MVRA, the district court ordered defendants to pay CoBank $305,743.33, which included $137,422 for losses associated with the transactions and $168,321.33 for costs and attorneys' fees incurred in connection with the investigation and prosecution of the case. Defendants appealed from both the judgment of conviction and the restitution order entered against them.

Mandatory Victims Restitution Act of 1996

The MVRA mandates restitution for the victim of certain federal crimes, including "any offense against property" that is "committed by fraud or deceit in which [a victim] has suffered a…pecuniary loss." 18 U.S.C. §§3663A(a)(1), (c)(1). Under the MVRA, a "victim" is defined broadly as "a person *directly and proximately harmed* as a result of the commission of [the] offense," and includes corporations. 18 U.S.C. §3663A(a)(2); see also 1 U.S.C. §1.

When a victim "has received compensation from insurance or any other source with respect to a loss," the MVRA also requires that the court "order that restitution be paid to the person who provided or is obligated to provide the compensation." 18 U.S.C. §3664(j)(1). Pursuant to the Supreme Court's ruling last year in *United States v. Lagos*, 138 S. Ct. 1684 (2018), corporations are not entitled to windfall compensation for the costs and expenses associated with conducting internal investigations or related civil and bankruptcy proceedings under §3663A(b)(4) of the MVRA.

> The Second Circuit ruled that the MVRA "does not supply a windfall for those who independently enter into risky financial enterprises through no fault of the fraudsters," where the financial loss at issue was not proximately caused by the defendant's criminally fraudulent conduct.

Second Circuit's Precedent

Before *Calderon*, the Second Circuit had a "well established" rule that "fluctuation in market prices does not excuse a defendant from paying full restitution for monies stolen in the course of a fraudulent scheme." *United States v. Onua*, 493 F. App'x 209, 211–12 (2d Cir. 2012) (citing *United States v. Paul*, 634 F.3d 668, 678 (2d Cir. 2011)). When determining the amount of restitution, the Second Circuit adheres to the strict rule that "the victim's loss must be the result of the fraud." *Paul*, 634 F.3d at 676.

As the restitution doctrine has evolved, the Second Circuit has distinguished between securities fraud cases and run-of-the-mill financial fraud cases involving fraudulently obtained loans. With respect to securities fraud, the Second Circuit reasoned that "many factors may cause a decline in share price between the time of the fraud and the revelation of the fraud" and, therefore, a court must take into account "the extent to which a defendant's fraud, as distinguished from market or other forces, caused shareholders' losses." *United States v. Rutkoske*, 506 F.3d 170, 179 (2d Cir. 2007). By contrast, in fraud cases involving fraudulently obtained loans, the Second Circuit has been more inclined to dismiss a defendant's arguments that a victim's loss resulted from market conditions, like the 2008 housing market collapse, if the court found that defendant's own conduct induced the fraudulently obtained loans. *United States v. Turk*, 626 F.3d 743, 751 (2d Cir. 2010). See, e.g., *United States v. Frenkel*, 682 F. App'x 20 (2d Cir. 2017) (rejecting defendant's arguments to attribute loss to the real estate market collapse).

Second Circuit's Opinion

On appeal, defendants in *Calderon* argued that the defrauded banks did not qualify as "victims" under the MVRA because the banks were not "directly and proximately harmed" by the defendants' fraud. 18 U.S.C. §3663A(a)(2). Accordingly, the ultimate question before the Second Circuit was whether the defrauded banks' financial losses were the

result of defendants' fraud.

Pointing to its well-established jurisprudence on loss causation in the MVRA context, the Second Circuit first noted its prior finding that "[t]he MVRA's proximate causation requirement is . . . akin to the well-established requirement that there be 'loss causation' in securities-fraud cases and not merely transaction ('but-for') causation." *Calderon*, 2019 WL 6482379, at *15. Proximate cause, not but-for causation, therefore was the appropriate causation standard to apply. Proximate cause is a "flexible concept" with a "central goal of . . . limit[ing] the defendant's liability to the kinds of harms he risked by his conduct, the idea being that if a resulting harm was too far outside the risks his conduct created, it would be unjust or impractical to impose liability." Id. In the context of investment losses, "[a] misstatement or omission is the proximate cause of an investment loss for the purposes of imposing restitution, if the risk that caused the loss was within the zone of risk *concealed* by the misrepresentations and omissions alleged by a disappointed investor." Id. Therefore, to establish loss causation, "a plaintiff must allege that the *subject* of the fraudulent statement or omission was the cause of the actual loss suffered." Id.

Next, the Second Circuit analyzed the concealed risks in *Calderon*. The court found that the fraudulently altered shipping documents concealed two risks from CoBank and Deutsche Bank. *First*, the fraud concealed the risk that IIB would refuse to honor the letters of credit because the defrauded banks failed to demand compliant documents. *Second*, the fraud concealed the risk that the USDA would decline to reimburse the defrauded banks because the transactions were not compliant with GSM-102 program requirements. "Neither of these risks[] even arguably materialized," the court reasoned, because IIB's default was caused by a wholly unrelated reason: its financial collapse due to the global financial crisis. Id. at 16. That, the court reasoned, was "the actual risk that materialized" in Calderon. Id.

The Second Circuit also distinguished *Calderon* from *United States v. Paul*, 634 F.3d 668 (2d Cir. 2011), which concluded that a defendant's fraud "proximately caused" an injury for purposes of the MVRA. The court explained that the defendant in *Paul* misrepresented his creditworthiness and, "even if market forces may have contributed to the decline in the value of the collateral," defendant's financial ability to repay the loans was "clearly within the zone of risk concealed by his fraud." *Calderon*, 2019 WL 6482379, at *16. By contrast, in *Calderon*, defendants' misrepresentations were not related to the defrauded bank's assessment of the foreign banks' creditworthiness because the USDA and the defrauded banks had pre-approved participation in the GSM-102 program "*before* the [d]efendants presented the fraudulent documents to the [defrauded] banks." Id. Therefore, the decision to offer the foreign loans was not influenced by defendants' misconduct. Accordingly, the Second Circuit held that CoBank and Deutsche Bank were not "victims" under the MVRA because defendants did not proximately cause their losses.

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Echoing the Supreme Court's skepticism about windfall awards in last year's *Lagos* decision, the court emphasized that "the MVRA provides redress to the victims of fraud, but it does not supply a windfall for those who independently enter into risky financial enterprises through no fault of the fraudsters." Id. at *17. For these reasons, the court held that *neither* the USDA *nor* the banks were entitled to restitution for losses caused by defendants' participation in the structured third-party transactions at issue in *Calderon*, or for expenses incurred in connection with the investigation, prosecution, or related proceedings. Accordingly, the Second Circuit reversed the district court's $18.8 million restitution award in its entirety.

Conclusion

Calderon applies to financial frauds in which the potential "victims" enter into risky financial enterprises through no fault of those who committed fraud. The decision is consistent with the Supreme Court's decision in *Lagos*, limiting the ability of corporate victims to obtain restitution (especially large windfall awards) from criminal defendants under the MVRA.