

SECOND CIRCUIT REVIEW

Second Circuit Proscribes Restitution Based On Defendant's Illicit Gains

This month, we discuss *United States v. Zangari*,¹ in which the U.S. Court of Appeals for the Second Circuit, in a matter of first impression in this circuit, held that restitution paid by a criminal defendant must be based on the victim's loss rather than the defendant's gain. The court's opinion was written by Judge José A. Cabranes, with Judges Rosemary S. Pooler and Richard C. Wesley joining the opinion. In its opinion, the court construed the Mandatory Victims Restitution Act (MVRA),² the federal statute that delineates a federal district court's power to order restitution in criminal cases. After reviewing the relevant provisions of the MVRA and decisions from seven of its sister circuits addressing the same question, the court concluded that the MVRA requires that restitution be calculated with reference to the victim's actual loss.

Background

In April 2010, Salvatore Zangari pled guilty to an information charging him with participating in a conspiracy to defraud participants in securities lending transactions. Zangari had worked as a broker for eight years in the securities-lending departments of Morgan Stanley and, later, Bank of America. In that role, Zangari received illicit cash kickbacks totaling tens of thousands of dollars from sham finder's fees paid by the parties to transactions he had arranged.³

Securities lending involves a temporary trans-



By
**Martin
Flumenbaum**



And
**Brad S.
Karp**

fer of securities from a lender to a borrower. The loaned securities may be stock, bonds, or other securities. The borrower provides the lender with cash or other collateral as security for the loan. The borrower returns the securities to the lender when the lender demands return or an agreed-upon period of time expires.⁴

The court concluded that the Mandatory Victims Restitution Act requires that restitution be calculated with reference to the victim's actual loss.

Zangari's fraudulent scheme relied on a third party sometimes involved in securities lending transactions known as a "stock-loan finder." A stock-loan finder connects would-be borrowers with willing lenders and facilitates stock-loan transactions in return for a fee. While working as a broker, Zangari caused his employers, Morgan Stanley and Bank of America, to enter into stock-loan transactions with other financial institutions. Those other institutions paid finder's fees to a straw stock-loan finder run by an acquaintance of Zangari's co-worker. Zangari received kickbacks from those sham finder's fees.⁵

The District Court's Sentence

The U.S. District Court for the Eastern District of New York entered judgment against Zangari on Nov. 3, 2010. The district court sentenced Zangari to imprisonment, supervised release and community service and imposed a fine, a special assessment and restitution in the amount of \$65,600.

The district court's order of restitution relied on the presentence investigation report (PSR) prepared by the U.S. Probation Office. The PSR concluded that Zangari should pay \$65,600 in restitution under the MVRA, to be divided between two victims, Morgan Stanley and Bank of America. That sum was "expressly based on Zangari's gain from the fraud."⁶ Two days after his sentencing, Zangari appealed, challenging the order of restitution.

The Second Circuit's Decision

Restitution Order Made in Error. The Second Circuit began its analysis by observing that "[f]ederal courts have no inherent power to order restitution" and therefore, in this case, the "sentencing court's power to order restitution... depends upon, and is necessarily circumscribed by," the MVRA.⁷

The MVRA, passed by Congress in 1996, establishes mandatory restitution for a variety of offenses. When a defendant is convicted of any of these offenses, the sentencing court must "order, in addition to, or in the case of a misdemeanor, in addition to or in lieu of, any other penalty authorized by law, that the defendant make restitution to the victim of the offense."⁸ The MVRA defines "victim" as "a person directly and proximately harmed as a result of the commission of an offense for which restitution may be ordered."⁹ It is the government's burden to "demonstrat[e] the amount of the loss sustained by a victim."¹⁰

MARTIN FLUMENBAUM and BRAD S. KARP are members of Paul, Weiss, Rifkind, Wharton & Garrison LLP. They specialize in complex commercial litigation and white-collar criminal defense matters. PHILIP KOPCZYNSKI, a litigation associate at the firm, assisted in the preparation of this column.

The Second Circuit found that the calculation of restitution in Zangari's case could not be squared with the dictates of the MVRA. The court reviewed several of its prior decisions finding that restitution is "compensatory" in nature, and "must be tied to the victim's actual, provable, loss."¹¹ The court contrasted this with Zangari's restitution order. In particular, the court found that Zangari's PSR, and the district court's restitution order, "substituted Zangari's gain from unlawful kickbacks in the place of the victims' losses."¹² Finding that "no provision" of the MVRA allows such a substitution, the court held "that a sentencing court ordering restitution under the MVRA may not substitute a defendant's ill-gotten gains for the victim's actual loss."¹³

The government argued that in some restitution cases—including Zangari's—referencing the defendant's illicit gains is not a substitute or impermissible shortcut. Instead, the government argued, the defendant's gains may be directly correlated to the victim's losses. Put simply, if a defendant defrauds someone out of \$5, then the defendant's gain and the victim's loss are identical: \$5.

The Second Circuit acknowledged that this argument has merit. The court wrote that "there may be cases where there is a direct correlation between gain and loss, such that the defendant's gain can act as a measure of—as opposed to a substitute for—the victim's loss."¹⁴ However, the court found that in Zangari's case, there was no such direct correlation, because Morgan Stanley's and Bank of America's losses were "not equivalent to the sham finder's fees...let alone the kickbacks in turn paid to Zangari and his coconspirators."¹⁵ Thus, the court concluded that the district court's order of restitution was made in error.

Judgment Still Affirmed. After finding that the restitution order contravened the MVRA, the court next considered whether to exercise its discretion to correct the error. Importantly, Zangari failed to timely object to the order of restitution in the district court. This meant the error was not preserved for appeal. In this circumstance, the discretionary power of the court of appeals is constrained. The court could order relief only if Zangari established "plain error" under applicable precedent.

The court found that Zangari failed to meet his burden with respect to two of the four requisite elements of plain error. Zangari failed to establish that the error (i) affected his substantial rights, and (ii) affected the fairness, integrity or public reputation of judicial proceedings. On both fronts,

the court cited the same shortcoming in Zangari's argument, which was that he did not present an alternative measure of the victims' losses.

The court observed that the restitution award in Zangari's case, if properly calculated under the MVRA, actually might have been higher than the amount the district court ordered. If that were true, the court said, then in fact there was "salutary error." Since Zangari did not establish otherwise, the court was not persuaded that the error prejudiced Zangari or undermined the proceedings. Therefore, the court affirmed the district court's judgment.¹⁶

The MVRA also gives courts an out: A court may order no restitution at all if it finds that complexities "would complicate or prolong the sentencing process to a degree that the need to provide restitution to any victim is outweighed by the burden on the sentencing process."

Conclusion

In *Zangari*, the Second Circuit joined seven of its sister circuits in holding that restitution must be based on the victim's losses, and may not be based on the defendant's illicit gains. The U.S. Courts of Appeals for the Third, Fourth, Fifth, Seventh, Eighth, Ninth, and Tenth circuits have already so held.¹⁷

The Second Circuit recognized that the calculation of a victim's losses may be challenging in some cases.¹⁸ It will be interesting to see how prosecutors and district courts address these challenges in future cases. The MVRA outlines certain steps that a sentencing court may take to assist it in setting the amount of restitution, such as requiring additional documentation or referring issues to a magistrate judge or special master.¹⁹

In the end, however, the MVRA also gives courts an out: A court may order no restitution at all if it finds that complexities "would complicate or prolong the sentencing process to a degree that the need to provide restitution to any victim is outweighed by the burden on the sentencing process."²⁰ With courts in the Second Circuit no longer able to use a defendant's gains as a proxy for a victim's losses, the practical import of *Zangari*

may be that restitution is ordered in fewer cases, particularly in complex fraud cases involving multiple victims with relatively modest losses.

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1. Docket No. 10-4546-cr, 2012 WL 1323189 (2d Cir. April 18, 2012).
2. 18 U.S.C. §§3663A-3664.
3. 2012 WL 1323189, at *1-2.
4. Id. at *1 (citing Securities Lending & Repurchase Agreements (Frank J. Fabozzi & Steven V. Mann eds., 2005)). The Second Circuit observed that the borrower in such a transaction "may be motivated by any number of factors," such as "the desire to cover a short position." Id.
5. Id. at *2.
6. Id. at *3.
7. Id. at *4.
8. 18 U.S.C. §3663A(a)(1). Zangari's conviction was covered by a provision of the MVRA concerning certain offenses "committed by fraud or deceit." Id. §3663A(c)(1)(A)(ii).
9. Id. §3663A(a)(2).
10. Id. §3664(e).
11. 2012 WL 1323189, at *4 (internal quotation marks and citations omitted).
12. Id. Such a substitution may be permissible in other contexts, such as when calculating an adjusted offense level under the U.S. Sentencing Guidelines. Id.
13. Id. at *5.
14. Id.
15. Id. at *6.
16. Id. at *8-9.
17. Third Circuit: *United States v. Badaracco*, 954 F.2d 928 (3d Cir. 1992); Fourth Circuit: *United States v. Harvey*, 532 F.3d 326 (4th Cir. 2008); Fifth Circuit: *United States v. Arledge*, 553 F.3d 881 (5th Cir. 2008); Seventh Circuit: *United States v. George*, 403 F.3d 470 (7th Cir. 2005); Eighth Circuit: *United States v. Chalupnik*, 514 F.3d 748 (8th Cir. 2008); Ninth Circuit: *United States v. Yeung*, 672 F.3d 594 (9th Cir. 2012); Tenth Circuit: *United States v. Galloway*, 509 F.3d 1246 (10th Cir. 2007).
18. 2012 WL 1323189, at *5. Indeed, *Zangari* itself involved losses that were difficult to calculate. As the Second Circuit explained, any loss in the securities lending transactions at issue in the case would consist of the opportunity cost of lost returns on additional collateral that might have been exchanged among the parties but for Zangari's fraud. Id. at *6.
19. Id. at *5; see 18 U.S.C. §3664(d).
20. 18 U.S.C. §3663A(c)(3)(B).