IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLORADO

Criminal Action No. 05-cr-00545-EWN

UNITED STATES OF AMERICA

Plaintiff,

v.

JOSEPH P. NACCHIO,

Defendant.

RESPONSE TO MOTION OF THE UNITED STATES
FOR ENTRY OF MONEY JUDGMENT

INTRODUCTION

Joseph P. Nacchio, by and through undersigned counsel, hereby opposes the motion of the United States [Doc 412] for a money judgment against Defendant Joseph P. Nacchio in the amount of $52,007,545.47, which represents the aggregate amount of all proceeds generated by the nineteen sale transactions -- including the cost of exercising the options -- corresponding to the nineteen counts of conviction.[1] Mr. Nacchio submits that the United States

[1] On April 19, 2007, Mr. Nacchio waived his right to have the jury determine the nexus between the counts of conviction and the amount subject to forfeiture, in favor of the Court making the determination as part of the sentencing proceeding. 4/19/07 Tr. at 11-13.

has incorrectly calculated the amount of proceeds "*obtained* . . . as the result of the commission of the offense giving rise to forfeiture." 18 U.S.C. § 981(a)(2)(A) (emphasis added); *see also*, 21 U.S.C. § 853(a)(1).

Mr. Nacchio was convicted of Counts 24 through 42, which charged him with "insider trading" in violation of 15 U.S.C. §§ 78j (§ 10b) and 78ff, SEC Rule 10b-5 (17 C.F.R. § 240.10b5) and SEC Rule 10b5-1 (17 C.F.R. § 240.10b5-1). "§ 10(b) and Rule 10b-5 are violated when a corporate insider trades in the securities of his corporation (sells stock) on the basis of material, nonpublic information." *United States v. O'Hagan*, 521 U.S. 642, 651-52 (1997). The indictment also seeks forfeiture pursuant to 18 U.S.C. § 981(A)(1)(c), 18 U.S.C. § 1956(c)(7)(A), 18 U.S.C. § 1961(1)(D), and 28 U.S.C. § 2461(c), of "a sum of money . . . representing the amount of proceeds obtained as a result of the offenses." [Doc. 1 at 6].

The amount of money "obtained" by Mr. Nacchio did not include the $5.50 per share option price or commission fees that were a direct cost of selling his shares, and were deducted from the amount of money he received from the sale of the securities following the exercise of the options. Nor did the amount "obtained" include over $16 million dollars in taxes that was paid directly by Qwest to the federal government and the states of Colorado and New Jersey prior to Mr. Nacchio obtaining any proceeds of the sales. The jury found that Mr. Nacchio sold shares of Qwest stock based upon material inside information between April 26, 2001, and May 29, 2001, and the government's own evidence

establishes without dispute that Mr. Nacchio "obtained" approximately $28.6 million dollars from those transactions. The amount to be forfeited should not be greater than this amount.

Moreover, even the shares of stock sold on the basis of material inside information had a legitimate value, and are not entirely "illgotten gains." The purpose of the forfeiture statutes is to disgorge from the defendant the benefit of his "ill-gotten gains," and therefore, under the circumstances of this case, forfeiture should be limited to that amount of money resulting from the enhanced value created by the material inside information.

In his report, Daniel Fischel, an expert in the field of corporate and financial economics, has demonstrated that the amount of gain attributable to the material inside information is approximately $1.8 million. Professor Fischel has identified four dates following the insider trading period on which disclosures of the material inside information were made, and a fifth date on which an analyst report was published referencing information disclosed on one of the four disclosure dates. An analysis of the effect of these subsequent disclosures on the price of Qwest stock using well known and established techniques in financial economics shows that the portion of Mr. Nacchio's sales proceeds that can be attributed to inside information and therefore, identified as "ill-gotten" gains, is no more than $1,832,561.

APPLICABLE LEGAL PRINCIPLES

The Civil Asset Forfeiture Reform Act of 2000 provided, in effect, that civil forfeiture pursuant to 18 U.S.C. § 981(a)(1)(C), through the application of 18 U.S.C. §§ 1956 and 1961, is authorized for offenses that include "fraud in the sale of securities," and could be sought as part of the sentence in a criminal case. 28 U.S.C. § 2461(c). The 2000 enactment also added a definition of proceeds to 18 U.S.C. § 981(a), which provides in relevant part that:

> (A) In cases involving illegal goods, illegal services, [and] unlawful activities . . . the term "proceeds" means property of any kind *obtained* directly or indirectly, as the result of the commission of the offense giving rise to forfeiture . . .
>
> (B) In cases involving lawful goods or lawful services that are sold or provided in an illegal manner, the term "proceeds" means the amount of money *acquired* through the illegal transactions resulting in the forfeiture, *less the direct costs incurred* in providing the goods or services.

18 U.S.C. § 981(a)(2) (emphasis added). 21 U.S.C. § 853(a)(1) similarly provides in relevant part that:[2]

> [a person] shall forfeit to the United States . . . any property constituting, or derived from, any proceeds the person *obtained* . . . as a result of [a violation covered by the statute].

[2] Although referenced by the government in its motion, the provisions of §853 are not applicable to the issues addressed here because 28 U.S.C. §2461(c) makes clear that only the "procedures" of 21 U.S.C. § 853 apply.

(emphasis added). Forfeiture is "gain based." Therefore, there are no proceeds, and there can be no forfeiture, where proceeds were not received by the defendant. *United States v. Genova*, 333 F.3d 750, 761-2 (7th Cir. 2003).

It is well recognized that the forfeiture statutes are designed to force those convicted of criminal offenses to disgorge their ill-gotten gains. *See e.g., United States v. Masters*, 924 F.2d 1362, 1369 (7th Cir. 1991); *United States v. Milicia*, 769 F. Supp 877, 889 (E.D.Pa. 1991) ("The purpose of Congress was to give the prosecutor the ability to destroy a drug dealer's power base," *citing, Russello v. United States*, 464 U.S. 16 (1983)). With these purposes in mind, courts have held, even prior to the 2000 act and the addition of a definition of "proceeds," that only "net profits," which allowed for the deduction of direct costs, were forfeitable. *United States v. Masters*, 924 F.2d at 1369-70; *United States v. Lizza Industries,* 775 F.2d 492, (2d Cir. 1985), *cert. denied,* 475 U.S. 1082, 106 S.Ct. 1459 (1986); *United States v. Elliott*, 727 F.Supp. 1126, 1128 (N.D. Ill. 1989).

ARGUMENT

1. At A Minimum, Forfeiture Should Not Include The Amount Of Money Attributable To Direct Costs

The government concedes that in calculating Mr. Nacchio's gain from the offenses in the context of determining the Sentencing Guideline level, the $5.50 per share paid by Mr. Nacchio to exercise his options and sell his shares should not be included. Here, however, the government seeks forfeiture of the entire

amount of proceeds generated by the stock sale transactions corresponding to the counts of conviction, including the $5.50 per share paid to exercise the options. The government relies on a statutory provision that is not applicable to this case, and lists a number of cases, none of which are analogous to this case, to support its position that the Court should order forfeiture of the "gross amount of the proceeds, not some smaller amount," *citing U.S. v. Keeling,* 253 F.3d 533, 537 (10th Cir. 2000). Government Motion [Doc 412] at 5.

The government's position is wrong because not only are the substantive provisions of 21 U.S.C. § 853, the drug forfeiture statute, not applicable here as noted above, but more importantly, the critical distinction relevant to the facts of this case is not whether the amount to be forfeited should include "gross proceeds" as opposed to "net profits." See e.g., *U.S. v. Keeling,* 253 F.3d at 537. Monies not obtained are not proceeds at all. Even § 853 recognizes that before the issue of what is "derived from" the proceeds arises, the proceeds must first be "obtained."

The statute that provides for forfeiture in this case also makes this clear. Under either of the potentially applicable definitions of "proceeds" in 18 U.S.C. § 981(a)(2), Mr. Nacchio did not "obtain" or "acquire" the amount of money spent to exercise the options. However, the statute speaks even more directly to the issue of "direct costs." Since trading in securities is generally a lawful activity, the offense of trading based upon inside information clearly involves "lawful goods... sold in an illegal manner." 18 U.S.C. § 981(a)(2)(B). This provision

specifically provides that "direct costs" are not included in the amount to be forfeited. *Id.* In at least one other case, the government has conceded this very point. *United States v. Elliott*, 727 F.Supp. 1126, 1128-29 (N.D. Ill. 1989) (In RICO/securities fraud forfeiture case, government conceded that forfeited amount would not include direct costs associated with purchasing the shares, such as the purchase price of the stock and interest charged on the defendant's margin account.); see also, *United States v. Lizza Industries,* 775 F.2d 492, (2d Cir. 1985), *cert. denied,* 475 U.S. 1082, 106 S.Ct. 1459 (1986) (forfeiture calculation upheld where district court deducted direct costs associated with each project for which they had been indicted as such method was consistent with purpose of the RICO statute); *United States v. Masters*, 924 F.2d at 1369-70.

In this case, Mr. Nacchio's option costs were approximately $7.315 million, and another approximately $60,000 was expended on commissions and fees. See Chart and supporting documents, attached as Exhibit 1 to our Response to the Presentence Report. Backing these direct costs out of the amount to be forfeited leaves approximately $44.6 million.

2. Mr. Nacchio Also Did Not Obtain, And Never Had The Benefit Of The Monies That Were Immediately Deducted And Paid To The Government And There Is No Basis To Support Forfeiture Of This Additional $16 Million

As indicated above, the applicable statutory provision makes clear that the "proceeds" to be forfeited must first be "obtained" or "acquired." 18 U.S.C. § 981(a)(2)(A) and (B). Subsection B recognizes that even monies "acquired" and then expended as direct costs should not be forfeited. Under the circumstances

of this case, there is no reason to distinguish between the $5.50 per share cost and the approximate $16 million withheld and immediately paid by Qwest to the federal government and the states of Colorado and New Jersey – neither amounts were ever obtained or acquired by Mr. Nacchio.

The government's motion does not address this point, except to cite to *Keeling* for the proposition that a defendant should be forced to forfeit "gross proceeds" even where the majority of the proceeds had not gone to the defendant. Government Motion [Doc 412] at 5, citing, *U.S. v. Keeling,* 253 F.3d at 537. The proceeds in *Keeling* didn't go to the defendant because he paid them to his drug supplier. Again, the issue here is not about "gross proceeds" versus "net profits." According to the statute, the proceeds first have to be obtained or acquired before they are subject to forfeiture.[3]

The $16 million, which was withheld and immediately paid by Qwest directly to the government and never received by Mr. Nacchio, should not be subject to forfeiture. Mr. Nacchio never had the use of these funds, and therefore, it never constituted a "gain" to him that requires disgorgement.

3. The True Gain To Mr. Nacchio From The Insider Trading Violations In This Case Is The Amount Of Money Attributable To The Material Inside Information, Measured By The Decrease In

[3] The government lists in a footnote (Government Motion at 6, n.2) a number of cases that support forfeiture of "gross proceeds" or "gross receipts," including one that cautions against the "unwarranted complexities in the administration of the RICO forfeiture statute" by allowing for the deduction of taxes paid on a salary subject to forfeiture. *See U.S. v. DeFries*, 129 F.3d 1293 (D.C. Cir. 1997). For all of the reasons discussed above, these cases are not applicable here. Furthermore, in *DeFries*, and the cases it cites, the tax payments were made after they were obtained by the defendant, unlike the circumstances here.

Stock Price Immediately Following Disclosure Of The Material Information

In order to fully accomplish the objectives of forfeiture and remove the proceeds of the illegal activity, the illegal activity must first be identified. Again, the analysis of what and how much is forfeitable under the circumstances of this case must begin with the statutory provision providing for forfeiture. 18 U.S.C. § 981(a) provides for forfeiture of property that "constitutes or is derived from proceeds traceable to" the offense of securities fraud, which here involves the sale of stock based upon inside information.

An insider trading case is simply not analogous to the operation of a drug enterprise, a racketeering case, or a money laundering case where all of the money obtained is directly related to the criminal activity, or even to a more classic theft or fraud case where the proceeds are wholly derived from illegal conduct. In those cases, as the courts have recognized, there is a purpose served by removing all proceeds remotely connected to the criminal activity in order to put the criminal out of business. None of the cases cited by the government in support of its position that the entire amount of the money generated by the sales should be forfeited involved securities fraud or insider trading. This is not surprising since, as indicated above, criminal forfeiture did not even apply to securities fraud cases until 2000 when 28 U.S.C. §2461 was amended to provide for criminal forfeiture in cases that previously only provided

for civil forfeiture. Therefore, much of the body of law dealing with forfeiture in these other contexts is inapplicable.

In one of the cases cited by the government in support of the proposition that "gross proceeds" are subject to forfeiture, the Forth Circuit recognized that "[t]he proper measure of criminal responsibility generally is the harm that the defendant caused, not the gain that he realized from his conduct." *United States v. DeFries*, 129 F.3d 1293, 1314 (D.C. Cir. 1997). The applicability of this principle should not depend on whether its application results in a greater or lesser amount subject to forfeiture. Even accepting that there may be a punitive aspect intended by forfeiture, courts must employ some reasonable measure of the harm. For all of the reasons discussed in Mr. Nacchio's Response to the Presentence Report dealing with the proper measure of the harm caused by Mr. Nacchio's trades, the Court should use the methodology employed by Professor Daniel Fischel to measure the harm caused by the counts of conviction.

This approach is further supported by civil disgorgement cases, which are applicable to forfeiture actions brought pursuant to 18 U.S.C. § 981.[4] The U.S. Supreme Court has recognized that forfeiture actions brought under 18 U.S.C. §

[4] As noted in our Response to the Presentence Report, there is overwhelming precedent for applying civil common securities law to criminal securities cases. "It is ... settled that the same standards apply to civil and criminal liability under the securities law." *United States v. Gleason*, 616 F.2d 2, 28 (2d Cir. 1979); *accord*, *United States v. Causey*, 2005 WL 2647976, *2 (S.D. Tex. 2005) (citing *Gleason*); *see also United States v. Dowlin*, 408 F.3d 647, 658 (10th Cir. 2005) (in a criminal appeal, court cited to 10th Circuit civil securities opinions for elements of securities fraud); *Chiarella v. United States*, 445 U.S. 222, 226 (1980).

981 were intended by Congress to be civil and remedial in nature. *United States v. Ursery*, 518 U.S. 267, 288-291, 176 S.Ct. 2135, 2147-2149 (1996).

The purpose of disgorgement in securities fraud cases is to deprive the wrongdoer of his ill-gotten gains and to deter him and others from repeating the unlawful activity by making such a violation of the securities laws unprofitable. *Sec. Exch. Comm'n v. Wolfson*, No. 2:02 CV 1086 TC, 2006 WL 1214994, at *8 (D. Utah May 5, 2006); see also, *Sec. Exch. Comm'n v. Rind*, 991 F.2d 1486, 1491-92 (9th Cir. 1993). Civil forfeitures "are designed to…confiscate property used in violation of the law, and to require disgorgement of the fruits of illegal conduct." *U.S. v. Ursery*, 518 U.S. 267, 284 (1996); *United States v. Elliott*, 714 F.Supp. 380, 381-2 (N.D. Ill. 1989); *Sec. Exch. Comm'n v. Blackwell*, 477 F.Supp. 2d 891, 913-14 (S.D. Ohio 2007).

Numerous civil cases have held that the amount of illicit gain in an insider trading case is generally the difference between the value of the shares when the insider sold them while in possession of the material, nonpublic information, and their market value a reasonable time after public dissemination of the inside information. *S.E.C. v. Happ*, 392 F.3d 12, 31 (1st Cir. 2004); *SEC v. Patel,* 61 F.3d 137, 139 (2d Cir. 1995); *SEC v. Shapiro,* 494 F.2d 1301, 1309 (2d Cir.1974); *cf., SEC v. MacDonald,* 699 F.2d 47, 54-55 (1st Cir. 1983) (en banc) (where court considered how to quantify the "profits and interest wrongfully obtained" from insider trading by measuring the increased value of the shares at a reasonable time after dissemination of the information in order to ensure the

"equitable" objective of equally treating different insiders who committed precisely the same fraudulent act).

Empirical studies which calculate the value of material inside information are well recognized. *See, e.g.*, *Basic Inc. v. Levinson*, 485 U.S. 224 (1988) (recognizing that the market price of shares traded on well-developed markets reflect all publicly available information); *Oran v. Stafford*, 226 F.3d 275, 282 (3d Cir. 2000) (recognizing basic economic insight that in an open and developed securities market, material information is immediately incorporated into the stock price, and the materiality can be measured by looking to the movement in the period immediately following disclosure).

Mr. Nacchio respectfully submits that the report prepared by Professor Daniel Fischel, an expert in the field of corporate economics and financial markets (attached as Exhibit 3 to our Response to the PSR), explains the methodology used to calculate the gain resulting from the offenses of conviction in accord with the legal principles referenced above. Professor Fischel concludes that the value of the gain realized by Mr. Nacchio from selling his Qwest shares based upon the material inside information in this case is no more than $1.8 million, and that is the amount that should be subject to forfeiture.

Respectfully submitted this 6th day of May, 2007.

s/Herbert J. Stern
Herbert J. Stern
hstern@sgklaw.com
Jeffrey Speiser

jspeiser@sgklaw.com
Edward S. Nathan
enathan@sgklaw.com
Alain Leibman
aleibman@sgklaw.com
Mark W. Rufolo
mrufolo@sgklaw.com
Stern & Kilcullen, LLC
75 Livingston Avenue
Roseland, New Jersey 07068
(973) 535-1900
(973) 535-9664 (facsimile)
s/John M. Richilano
John M. Richilano
jmr@rglawoffice.net
Marci A. Gilligan
mgilligan@rglawoffice.net
Richilano & Gilligan, P.C.
633 17th Street, Suite 1700
Denver, CO 80202
(303) 893-8000
(303) 893-8055 (facsimile)

CERTIFICATE OF SERVICE

I hereby certify that on this 6th day of May 2007, a true and correct copy of the foregoing **DEFENDANT JOSEPH P. NACCHIO'S RESPONSE TO MOTION OF THE UNITED STATES FOR MONEY JUDGMENT** was served on the following via the USDC CM/ECF system:

James O. Hearty
james.hearty@usdoj.gov
victoria.soltis@usdoj.gov
USACO.ECFCriminal@usdoj.gov

Cliff Stricklin
Cliff.stricklin@usdoj.gov

Leo J. Wise
leo.wise@usdoj.gov
dorothy.burwell@usdoj.gov

Colleen Ann Conry
colleen.conry@usdoj.gov

Paul E. Pelletier
paul.pelletier@usdoj.gov

Kevin Traskos
kevin.traskos@usdoj.gov

s/Mark Rufolo
Mark Rufolo