

# THE SODERQUIST CENTER

## **Securities Fraud Silence Goes Unpunished**

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Citigroup recently agreed to pay \$1.66 billion to Enron's bankruptcy estate to settle legal claims it helped Enron's management deceive investors. It is legally and ethically right to hold responsible those who help others commit crimes. It is surprising, however, that Citigroup agreed to the settlement given the U.S. Supreme Court's January ruling in *Stonebridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*

The Court's decision in *Stonebridge* made it more difficult for investors to sue third parties who help a corporation's management commit securities fraud. The Court's long-awaited decision surprised many legal experts because it contradicted the views of most of the Securities and Exchange Commission's members.

### **Cable box scheme**

The case involved a scheme by Charter Communications, Inc. to inflate its revenues to meet the financial expectations of securities analysts. To do so, Charter needed the help of two of its suppliers, Scientific Atlanta and Motorola.

Charter is a cable operator. Scientific-Atlanta and Motorola supplied Charter with digital cable set top boxes that Charter provided to its customers. In the scheme to inflate revenues, Charter agreed to overpay both companies \$20 on each box it bought from them. Scientific-Atlanta and Motorola returned the over payments to Charter by buying advertising from the company. Charter reported the advertising buys as revenue and capitalized its buy of the boxes.

Scientific-Atlanta and Motorola then helped Charter fool its auditors into approving the false financial statements. The companies drafted false documents showing the boxes' sales and advertising buys as separate deals. Scientific-Atlanta's false documents showed it increased the cost of each box provided to Charter by \$20.

Motorola prepared a contract showing that Charter agreed to buy a specific number of boxes and pay liquidated damages of \$20 for each box not bought. The parties made the

contract with the understanding that Charter would breach the contract and pay liquidated damages.

### **Third-party pardon**

Charter's investors, whose stocks declined in value after Charter's inflated income become known, filed a class-action law suite against all three companies. The Supreme Court, however, held Scientific-Atlanta and Motorola not liable for the losses suffered by Charter's investors.

How could the two companies not be liable? Without their help and unethical conduct Charter's plan to inflate revenues and deceive investors could not have succeed.

The Court held, however, the two companies never directly deceived Charter's investors. Deception - and the reliance on the deception by those injured - is essential to proving fraud. Scientific-Atlanta and Motorola never mislead Charter's investors by making public statements about the value of Charter's stock or its financial condition.

What about the companies silence about Charter's plan to mislead investors with false financial reports? The Court held the two companies lacked a duty to disclose the truth about Charter's finances, even though they took part in Charter's fraud.

The Court's ruling is illogical and simply wrong. It protects unethical and illegal conduct. How can parties who take part in a securities fraud scheme not be liable to injured investors simply because they kept silent about the fraud and their own misdeeds?

Seemingly, the Supreme Court considers silence golden when third parties help a company commit securities fraud.