Shielding Wall Street, US Supreme Court rejects Enron fraud case

Don Knowland
23 January 2008

Without explanation, the US Supreme Court Tuesday dismissed a lawsuit brought by pension and investment funds against major Wall Street banks for their part in the massive financial fraud carried out by the Enron Corporation, the Houston-based energy trading giant.

The suit sought to recover some $40 billion that were lost when Enron went bankrupt in late 2001. It charged the banks, including Merrill Lynch, Credit Suisse Group, Barclays Plc and other leading financial houses, with helping company executives cover up a mounting cash flow problem by disguising loans as revenues, setting up off-the-books partnerships and hiding losses in order to defraud investors.

The rejection of the case—an appeal of a lower court ruling barring the funds from suing the banks—came just one week after a 5-3 ruling that protected banks and other businesses that help companies falsify their financial pictures in order to defraud investors from lawsuits based on the federal securities fraud laws.

That ruling, issued in the case of Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc., together with the dismissal of the Enron appeal are only the latest in a series of pro-business, anti-investor decisions from the Court designed to kill securities fraud lawsuits.

The Stonebridge decision was written by Justice Anthony Kennedy, who failed to take part in the deliberations on the Enron case. While Kennedy offered no explanation for his absence, the justice's son is an investment banker at Credit Suisse in New York City.

The Stonebridge case charged that an accounting fraud by Charter Communications Inc., a St. Louis cable operator, was carried out with the collaboration of cable-television box manufacturers Motorola and Scientific-Atlanta (now owned by Cisco systems).

According to the lawsuit, Charter overpaid Motorola and Scientific-Atlanta $17 million for cable boxes, which the two manufacturers then kicked back to the operators by purchasing advertising, allowing Charter to add the money to its books as phony revenue.

In writing the majority decision, Kennedy made it clear that a key consideration was that holding such companies accountable for investment fraud could be bad for Wall Street. Allowing shareholder suits in such cases, he wrote, "may raise the cost of being a publicly traded company under our law and shift securities offerings away from domestic capital markets."

Justice Stephen Breyer did not participate in the case, because he is a stockholder in Cisco Systems Inc., Scientific-Atlanta's parent company.

Even a brief review of the decision and the history of the federal antifraud securities laws reveals that the ruling is utterly cynical, dishonest and result-driven.

In the wake of the 1929 stock market crash and in response to widespread fraud in the securities industry, the US Congress enacted the Securities Act of 1933 and the Securities Exchange Act of 1934. The 1933 law regulates the initial distribution of company shares, and the 1934 Act, for the most part, regulates post-distribution trading.

The general anti-fraud provision of the 1934 Act, Section 10(b), states:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange... To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Securities and Exchange Commission [the SEC, a federal agency] may prescribe."

In 1942 the SEC adopted such a Rule, 10b-5, which provides that "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of any security."

Long ago, the Supreme Court approved suits for damages by private investors for violations of section 10(b) and SEC Rule 10b-5. Typically investors sue under the portion of Rule 10b-5 that forbids making false or incomplete statements. In those cases, the courts have required that the investors prove that they relied on fraudulent statements or a cover-up of information when buying or selling shares.

In a 1994 case, Central Bank of Denver v. First Interstate Bank, the Supreme Court decided that persons or businesses that knowingly or recklessly give "substantial assistance" to a company engaged in such deception cannot be held liable for defrauding investors. In a decision written by Justice Anthony Kennedy and backed by four other right-wing justices (former Chief Justice Rehnquist, retired Justice Sandra Day O'Connor and present Justices Antonin Scalia and Clarence Thomas), the Court refused, in the absence of a specific law passed by Congress, to apply the longstanding legal principle of aiding and abetting to those who help companies misrepresent or omit information in order to defraud investors, even if they themselves are not directly responsible for giving investors the misinformation.

In deciding the Central Bank case the Court however expressly recognized that the “commission of a manipulative act” was another, alternative basis for liability under 10(b) apart from directly making a misstatement. The Court decision said: “The absence of 10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability under the securities Acts. Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5.” The Court stressed that the plaintiffs in the Central Bank case had conceded that the defendant bank had not committed a manipulative or deceptive act within the meaning of 10(b).

But in the Stoneridge case decided last week, the cable box manufacturers were charged with engaging precisely in such a manipulative or deceptive act.

The box suppliers knew that Charter wanted to use the kickback of money from the inflated cable box purchases in the form of advertising sales to inflate the company’s revenue picture by $17 million. Charter used the scheme to issue quarterly reports that would meet Wall Street expectations for operating cash flow and maintain its share price.

In order to keep Charter’s auditing firm from discovering the link between Charter’s increased payments for the boxes and the advertising purchases, the companies drafted documents to make it appear the transactions were unrelated and conducted in the ordinary course of business. The cable box companies sent documents to Charter falsely stating they had increased production costs on the boxes. Also, the new set-top box agreements were also backdated to make it appear that they were negotiated a month before the advertising agreements.

A class action lawsuit was filed on behalf of purchasers of Charter’s shares against not only Charter, but the cable box companies as well. The lawsuit charged that the companies were liable because they knowingly participated in a scheme that was aimed at and succeeded in inflating Charter’s revenue. If the companies had not assisted Charter, Charter’s auditor would not have been fooled, and the false financial statements would not have been issued.

Under this “scheme liability” legal theory, many banks and other companies had been successfully sued for assisting in massive accounting fraud by the likes of Enron and WorldCom in the 1990s. Nonetheless, the cable box companies succeed in getting the case dismissed in the lower courts.

Justice Kennedy, who wrote the majority decision in the Stonebridge case, was also the author of the 1994 decision. This time Kennedy was again joined by the far-right wing bloc of Justices—Scalia and Thomas, along with current Chief Justice John Roberts and Justice Samuel Alito.

In refusing to hold the cable box companies liable, Kennedy wrote that since they had not themselves made the public misstatements as to Charter’s revenues, to hold them liable would in effect permit the sort of aider and abettor liability thrown out in the Central Bank case. The investors, Kennedy wrote, were required to show they relied on these the manufacturing companies’ deceptive actions but could not do so “except in an indirect chain that we find too remote for liability.”

This is legal sophistry. Kennedy and the majority ignored that the conduct alleged was critically different from the Central Bank case because the bank in that case did not itself engage in a proscribed deceptive act and, therefore, did not itself directly violate section 10(b) and Rule 10b-5. In other words, they ignored their express recognition in Central Bank that such conduct is an additional ground for liability beyond that arising from publicly making a misstatement.

There is no reason to impose the requirement that investors prove they relied on misinformation produced by the companies’ actions to find them liable. Under the plain language of the statute banning deceptive practices, the real question is instead whether the defendants’ conduct caused the investors to purchase their shares under false pretenses.

In a dissenting opinion in the Stoneridge case, Justice John Paul Stevens argued that the acts of the cable box companies were enough to impose liability because they had the foreseeable effect of causing investors to purchase their shares under false pretenses. The law has long treated a misrepresentation made to a third person the maker intends or has reason to expect will be repeated or its substance communicated to the victim the same as direct falsehoods for liability purposes. For all practical purposes the sham transactions the manufacturing companies engaged in had the same effect on Charter’s profit and loss statement as if they had themselves made false entries directly on Charter’s books.

The Stoneridge ruling cannot be seen as anything other than a political decision to serve the reactionary economic interests of finance capital. In an interview with the *New York Times*, J. Edward Ketz, an associate professor of accounting at Pennsylvania State University’s Smeal College of Business, called the ruling “a travesty of justice” and a “huge step backwards in the fight to prevent further accounting frauds from harming investors and the American economy.”

The ruling provoked an audible sigh of relief on Wall Street and from such employers’ groups as the National Association of Manufacturers, because of fear that a ruling in the investors’ favor would have left large numbers of companies and banks vulnerable to lawsuits over the massive fraud that has characterized the US economy.

The ruling is particularly timely given the unwinding of the sub-prime mortgage scandal. Many investment and commercial banks that might otherwise face liability to investors under the securities laws will be able now to dodge it. The banks created all sorts of formally separate “off balance sheet” entities to foist packages of such mortgages onto investors. They will argue that, as in Stoneridge, only those entities and not the banks themselves should be liable for any fraud relating to the real value of these mortgages.