Summer August 15, 2010

ANALYSIS OF THE 2010 SEC -- DELL INC ACCOUNTING FRAUD SETTLEMENT

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ACCOUNTING FRAUD IN PUBLIC MARKET COMPANIES:
AN ANALYSIS OF THE SEC -- DELL INC ACCOUNTING FRAUD SETTLEMENT

"Knowledge is power. Information is power. The secreting or hoarding of knowledge or information may be an act of tyranny…"[1]

Business and finance is conducted based on a set of written and traditional rules. The 'rule of law' is intended to be applied to business and finance, and in particular to the securities markets, where borrowers and savers meet to make a bargain about one another's needs; and as a consequence, where a significant percentage of individual retirement funds are invested.[2] Speaking on the subject of the Global Financial Crisis, Lord Justice Thomas stated:

> "The operation of a market economy depends upon the rule of law and its effectiveness. Our civil law has developed over the centuries a system that underpinned the capitalist market economy. As mercantile practices developed, they would be set within a legal framework of clear rights and obligations, often by judge made law, but more recently almost entirely by Parliament. That legal framework has been premised on the practice of the mercantile community to trust those with whom they do business and that they will carry out their bargains."[3]

It is estimated that securities fraud losses in the United States total more than US$ 400 billion per year.[4] US securities markets are the largest and most complex in the world and since the

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[1] Morgan, Robin T*he Demon Lover: The Roots of Terrorism* (2001)
[2] Steiner-Threkeld, Tom, '*Tri-party Repo Reform Focuses on Operational Improvements'*, Securities Industries News Source Media, December 22 2009 at 2
[3] Thomas L.J. *The Financial Crisis: The Role Of Law And Regulation* The Lord Merlyn-Rees Lecture University of Glamorgan 5 March 2009
[4] www.stopfraud.gov The website is maintained by the Financial Fraud Enforcement Task Force, a coalition of law enforcement, investigatory and regulatory agencies created by a 2009 Executive Order of United States President Barrack Obama.

Second World War have been the wellspring of most large financial transactions[5]. The quality of information emanating from the US securities markets and the perceived integrity of the regulation that underpins the efficient and effective operation of these markets is critical to the safe and efficient functioning of global financial markets. According to the FBI, this is the reason they diligently investigate every case of securities fraud[6] that is referred by FINRA, the SEC, or the various State and Federal regulatory bodies that oversee these markets. The assurance of proper regulation of US securities markets must be understood against the backdrop of some of the recent investor losses that have been suffered as a result of one narrow aspect of securities fraud, namely accounting fraud.

The author commented on the half trillion dollars of losses suffered by investors as a result of accounting frauds[7] in the United States, Canada, Australia, and the United Kingdom, and the fact that the *Sarbanes-Oxley Act 2002*[8] is a response to the losses suffered as a result of spectacular frauds such as Worldcom, Tyco, Adelphia and Enron. It is against the backdrop of these losses, the recent enactment of the *Dodd-Frank Wall Street Reform and Consumer Protection Act 2010*[9], and the commitment of the United States Securities Exchange Commission to both increase and improve their enforcement of the law as it relates to losses caused by accounting fraud, that this paper has been written.

In particular the author will address the very recent settlement of the accounting fraud charges leveled against Dell Inc, the world's second largest computer maker, and whether the settlement

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5 Committee on Payment Settlement Systems, Red Book Statistical Update (2009) Bank for International Settlements http://www.bis.org/cpss/paysys/UnitedStates.pdf at 5 August 2010

6 Federal Bureau of Investigation, Department of Justice (2010) http://www.fbi.gov/publications/fraud/securities_fraud.htm at 1 August 2010

7 Hansen, B, Lehman Brothers Failure, The Gatekeepers [2010] University of Auckland, Corporate Governance Centre http://www.business.auckland.ac.nz/Schoolhome/Research/Researchcentres/NZGovernanceCentre/Workingpapers/tabid/1139/Default.aspx

8 Pub.L. 107-204, 116 Stat. 745 (enacted July 30, 2002) In the United States Senate, the enactment is also known as the *Public Company Accounting Reform and Investor Protection Act 2002*, and in the House of Representatives the enactment is known as the *Corporate and Auditing Accountability and Responsibility Act 2002*. http://www.gpo.gov/fdsys/pkg/PLAW-107publ204/content-detail.html

9 Singed in to law by United States President Barrack Obama on 21 July 2010, but enacted effective 5 January 2010. http://www.gpo.gov/fdsys/pkg/BILLS-111hr4173ENR/pdf/BILLS-111hr4173ENR.pdf

provides comfort to investors that losses suffered as a result of accounting fraud will be prosecuted under rule of law, and losses will be recovered to the full extent of the capacity of the perpetrators to pay.

GENERAL BACKGROUND

The Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System (chaired by Nobel Prize winning Economist, Joseph Stiglitz) reporting to the UN in late 2009 reported:

> In spite of the widespread presumption in favor of private markets, research over the last three decades has shown that they do not in general produce efficient outcomes when **information is imperfect** and especially when information asymmetries mean that different individuals will have different information. Such information imperfections are particularly pervasive in financial (securities) markets.[10] [emphasis added]

The United States Congressional Oversight Committee for the Troubled Asset Relief Program, reporting to Congress on the Global Financial Crisis in 2009, observed that a dearth of accurate disclosure was the root cause of what they described as a series of successive bubbles and financial crises:[11]

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10 Stiglitz, Joseph E. Chairman, Bougrov, Andrei, Boutros-Ghali, Yousef, Fitoussi, Jean Paul, Goodhart, Charles A, Johnson, Robert, Sundaram, Jomo Kwame, Ndulo, Benno, Ocampo, José Antonio, Páez, Pedro, Venugopal, Reddy, Yaga, Persaud, Avinash, Ricupero, Rubens Ricupero, Sakakibara, Eisuke, Wieczorek-Zeul, Heidemarie, Yongding, Yu, Aziz, Zeti Akhtar, *Report of the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System, United Nations General Assembly,* September 21, 2009

11 Congressional Oversight Panel, *Special Report on Regulatory Reform, Modernizing the American Financial Regulatory System: Recommendations for Improving Oversight, Protecting Consumers, and Ensuring Stability* (2009) US Government Printing Office at p. 2 (http://cop.senate.gov/documents/cop-011410-report.pdf at 1 August 2010)

> "The first warning followed deregulation of the thrifts, when the country suffered the savings and loan crisis in the 1980s. A second warning came in 1998 when a crisis was only narrowly averted following the failure of a large unregulated hedge fund. The near financial panic of 2002, brought on by corporate accounting and governance failures, sounded a third warning. The United States now faces its worst financial crisis since the Great Depression. It is critical that the lessons of that crisis be studied to restore a proper balance between free markets and the regulatory framework necessary to ensure the operation of those markets to protect the economy, honest market participants, and the public "[12]

It was further reported to Congress that:

> "Markets have become opaque in multiple ways. Some markets, such as hedge funds and credit default swaps, provide virtually no information. Even so, disclosure alone does not always provide genuine transparency. Market participants must have useful, relevant [accurate] information delivered in an appropriate, timely manner. Recent market occurrences involving off-balance-sheet entities and complex financial instruments reveal the lack of transparency resulting from the wrong information disclosed at the wrong time and in the wrong manner."[13]

Securities markets are prone to abuses, and in particular in the quality of information that is meted out to the public. The Congressional Oversight Committee proffered a scathing indictment of the type of abuses that have occurred as a result of poor oversight, and a securities market structures that favour dishonest disclosure:

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[12] Ibid p. 1 Note that the hedge fund referenced in the quotation is Long Term Asset Management, which was exposed to a large Russian debt position, which they had arithmetically linked to various Asian bonds and currencies. When Russia defaulted on its debt obligations it caused a financial crisis in Asia because of arithmetic trades linking Russian bonds to the Thai Baht.

[13] Ibid. p. 3

"Financial markets are inherently volatile and prone to extremes. The government has a critical role to play in helping to manage both public and private risk. Without clear and effective rules in place, productive financial activity can degenerate into **unproductive gambling**, while sophisticated financial transactions, as well as more ordinary consumer credit transactions, can give way to **swindles and fraud**." [emphasis added]

- The intention of US legislators when Congress passed the *Securities Act 1933*, and the *Securities Exchange Act 1934*, along with a succession of securities laws[14] is to balance information asymmetries and make markets transparent[15] in order to prevent fraud, shams, cons, swindles, false statements, deceit, scams, cons, swindles, extortion, cheats, ploys, ruse, hoodwinks, confidence tricks, hoaxes, fraudulent misrepresentation,[16] and a host of other terms that have been used to describe abuses in securities markets. In other words, to make the same information available to all people at the same time in the same way, and to avoid the deep lacuna of dishonest disclosure that is particularly problematic in public markets.

CRIMINAL FRAUD

Recent media coverage of the "fraud charges" against Goldman Sachs[17] might lead a lay person to believe the words "fraud" or "investment fraud" or "securities fraud" always connote a criminal act, but in the case of Goldman Sachs, this has been shown to be untrue.[18]

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14 Excluding the *Financial Modernization Act 1999* and the *Private Securities Litigation Reform Act 1995*[14] which serve to reduce oversight, regulation, and prosecution. It should be noted that both these enactments were signed into law during the Clinton Administration at a time when both the Senate and the House of Representatives were under the control of the GOP, whereas the Executive Branch of government was under the control of the Democratic Party, namely President William J. Clinton.

15 Partnoy, Frank, *The Match King, Ivar Kreuger, The Financial Genius Behind a Century of Wall Street Scandals* Public Affairs, a member of the Perseus Book Group, 2009 at p. 205

16 Action Fraud, United Kingdom National Fraud Authority http://www.actionfraud.org.uk/types_of_fraud at 31 July 2010

17 Zuckerman, Gregory, Craig, Susanne, Ng, *SEC Alleges Firm Misled Investors on Securities Linked to Subprime Mortgages; Major Escalation in Showdown With Wall Street* Wall Street Journal 17 April 2010

A review of fraud claims against Investment Advisers, Dealer-Brokers, etc, reveals that SEC claims are largely civil with the primary purpose of recovering investor losses[19], rather than punishing wrong-doers. Because lay perceptions may be untrue, and because the lines between 'sharp practice', shams, various torts, misrepresentation actions in contract, and statutorily defined criminal acts, are frequently confused and conflated, it is important to understand how the constituent parts inter-relate, when one becomes the other, and when certain acts may not be fraudulent at all.

The United States, like Australia, is a federation of States with a Constitution which distributes power between the States and the Federal Government. In the United States until 1863 fraud was singularly under the purview of each State. A series of frauds perpetrated by contractors on the US Federal government caused a serious drain on the United States treasury.[20] President Abraham Lincoln urged Congress to pass *The* False *Claims Act 1863*, which made defrauding the US government a criminal offence.[21] In 1879 Congress passed the *Mail Fraud Act 1879* which criminalized a fraudulent act or scheme perpetrated through the United States Postal Service.[22]

The United States Supreme Court first ruled on the elements and application of the new mail fraud statue in 1896 where Justice Brewer delivered the decision of the entire court, tracking the language from the recent enactment:

> "…this was a scheme and artifice to defraud, and that the defendant did not [intend] that the bonds should mature, or that, although money was received, any

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[18] *SEC v Goldman Sachs & Fabrice Torre* U.S. Securities And Exchange Commission Litigation Release No. 21592 / July 15, 2010 **http://www.sec.gov/litigation/litreleases/2010/lr21592.htm**

[19] Ryan, Ellen M and Simmons, Laura E, Securities Class Action Settlements, 2009 Review and Analysis, Cornerstone Research, Stanford University Law School: http://securities.stanford.edu/

[20] Meyer, Jack A, *A Retrospective Look at Twenty Years of Fraud Fighting in America*, Tax Payers Against Fraud Education Fund (2006) p. 1

[21] Ibid.

[22] Law Encyclopedia. *West's Encyclopedia of American Law*. 1998 The Gale Group, Inc.

should be returned, but that it should be appropriated to his own use. In other words, he was trying to entrap the unwary, and to secure money from them on the faith of a scheme glittering and attractive in form, yet unreal and deceptive in fact and known to him to be such. So far as the moral element is concerned, it must be taken that the defendant's guilt was established.

But the contention on his part is that the statute reaches only such cases as at common law would come within the definition of "false pretenses" in order to make out which there must be a misrepresentation as to some existing fact, and not a mere promise as to the future. It is urged that there was no misrepresentation as to the existence or solvency of the corporation the Provident Bond & Investment Company, or as to its modes of doing business; no suggestion that it failed to issue its bonds to any and everyone advancing the required dues, or that its promise of payment according to the conditions named in the bond was not a valid and binding promise. And then as counsel say in their brief,

> "it [the indictment] discloses on its face absolutely nothing but an intention to commit a violation of a contract. If there be one principle of criminal law that is absolutely settled by an overwhelming avalanche of authority, it is that fraud, either in the civil courts or in the criminal courts, must be the misrepresentation of an existing or a past fact, or cannot consist of the mere intention not to carry out a contract in the future."

The question thus presented is one of vital importance, and underlies both cases. We cannot agree with counsel. The statute is broader than is claimed. Its letter shows this: "Any scheme or artifice to defraud." Some schemes may be

> promoted through mere representations and promises as to the future, yet are nonetheless schemes and artifices to defraud.[23]

In this seminal case the United States Supreme Court gave guidance about criminal fraud in the United States, namely that the proscription of fraud by the Federal government not be limited to past or present acts, but shall include a proven intention to carry out such future acts, provided that the evidence of same is material.[24] As pointed out, this was a departure from the common law in respect of both the tort of deceit and an action for fraudulent misrepresentation (Both issues are further explored later in this paper.) The Supreme Court clarified the materiality point nearly one hundred years later:

> "In general, a false statement is material if it has "a natural tendency to influence, or [is] capable of influencing, the decision of the decision- making body to which it was addressed." *United States* v. *Gaudin*, 515 U.S., 509 (quoting *Kungys* v. *United States*, 485 U.S. 759, 770 (1988) (internal quotation marks omitted)). In a prosecution under §7206(1), several courts have determined that "any failure to report income is material." *United States* v. *Holland*, 880 F.2d 1091, 1096 (CA9 1989); see 136 F.3d, at 1465 (collecting cases). Under either of these formulations, no jury could reasonably find that Neder's failure to report substantial amounts of income on his tax returns was not "a material matter."[25]

If "any failure to report income is material" (supra.) when determining whether the facts of a case indicate criminal fraud, one can analogize that an intentional failure to report the true income of a company, where the unreported or over-reported income is material and intentional,

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[23] *Durland v United States* (1896) 161 U.S. 306

[24] *Neder v United States* (1999) 97-1985 527 U.S. 1; 136 F.3d 1459

[25] Ibid. The Supreme Court footnotes clarify the interpretation of the statutes that govern securities fraud as set out herein: "The Restatement [(Second) of Torts §538 (1976)] instructs that a matter is material if: "(a) a reasonable man would attach importance to its existence or nonexistence in determining his choice of action in the transaction in question; or "(b) the maker of the representation knows or has reason to know that its recipient regards or is likely to regard the matter as important in determining his choice of action, although a reasonable man would not so regard it."

shall also be criminal fraud.[26] It should be further noted that the Supreme Court indicates that the elements of fraud, and its analogs, are common law terms. It was said:

> "The operative terms…on the other hand, "false pretenses, a false representation, or actual fraud," carry the acquired meaning of terms of art. They are common law terms, and, as we will shortly see in the case of "actual fraud," which concerns us here, they imply elements that the common law has defined them to include. See *Durland* v. *United States*, 161 U.S. 306, 312 (1896); *James Dickinson Farm Mortgage Co.* v. *Harry*, 273 U.S. 119, 121 (1927). Congress could have enumerated their elements, but Congress's contrary drafting choice did not deprive them of a significance richer than the bare statement of their terms."

The James Dickinson Farm Mortgage Co. appealed to the United States Supreme Court .a decision requiring the company to pay damages for fraud. This decision is helpful in understanding the distinction between civil actions for deceit, fraudulent misrepresentation, and fraud; and those that are prosecuted as criminal fraud. Justice Brandeis delivered the opinion of the entire Supreme Court:

> "Another contention is that the statute violates the due process clause in providing that actionable fraud shall exist not only when there is "a false representation of a past or existing material fact," but also if there is a "false promise to do some act in the future, which is made as a material inducement to another party to enter into a contract and but for which promise said party would not have entered into said contract. . . ."
>
> "The contention is groundless. To modify the substantive and procedural law so that recovery may be had in tort for a breach of contract is well within the power of a [State]. An action for deceit was long the sole remedy for a breach of warranty, and it still lies in some jurisdictions. *See F. L. Grant Shoe Co. v. Laid,*

[26] *Securities and Exchange Commission v Worldcom, Inc.* [2003] S.D.N.Y., Southern District

> 212 U. S. 445, 212 U. S. 449; *Nash v. Minn. Ins. & Trust Co.,* 163 Mass. 574, 587; *Carter v. Glass,* 44 Mich. 154. Recovery in contract on a tort that is waived is common. *See Crawford v. Burke,* 195 U. S. 176, 195 U. S. 194. Here, moreover, no such change is brought about by the statute. Some courts have long recognized that a false promise is a species of false representation for which there is remedy in tort, *Church v. Swetland,* 243 F.2d 9, 294-295; *Wright v. Barnard,* 248 F.7d 6, 775, as, for instance, where goods are obtained on credit by a purchaser who does not intend to pay for them. *See Burrill v. Stevens,* 73 Me. 395; *Stewart v. Emerson,* 52 N.H. 301."

The express regulation of securities fraud came in the wake of the Great Crash of 1929 and in particular certain revelations about Ivar Krueger, whose companies' shares in 1933 were the most widely held securities in the world.[27] The Supreme Court set out the evolution of the legislation as follows:

> "The magnitude of the federal interest in protecting the integrity and efficient operation of the market for nationally traded securities cannot be overstated. In response to the sudden and disastrous collapse in prices of listed stocks in 1929, and the Great Depression that followed, Congress enacted the Securities Act of 1933 (1933 Act), 48 Stat. 74, and the Securities Exchange Act of 1934 (1934 Act), 48 Stat. 881. Since their enactment, these two statutes have anchored federal regulation of vital elements of our economy.
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> Securities and Exchange Commission (SEC) Rule 10b–5, 17 CFR §240.10b–5 (2005), promulgated in 1942 pursuant to §10(b) of the 1934 Act, 15 U. S. C. §78j(b), is an important part of that regulatory

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[27] Partnoy, Frank, *The Match King, Ivar Kreuger, The Financial Genius Behind a Century of Wall Street Scandals* Public Affairs, a member of the Perseus Book Group, 2009 pp. 206 - 210

scheme. The Rule, like §10(b) itself,[4] broadly prohibits deception, misrepresentation, and fraud “in connection with the purchase or sale of any security.”[5] The SEC has express statutory authority to enforce the Rule. See 15 U. S. C. §78u (2000 ed. and Supp. III). Although no such authority is expressly granted to private individuals injured by securities fraud, in 1946 Judge Kirkpatrick of the United States District Court for the Eastern District of Pennsylvania, relying on “the general purpose” of the Rule, recognized an implied right of action thereunder. *Kardon* v. *National Gypsum Co.*, 69 F. Supp. 512, 514. His holding was adopted by an “overwhelming consensus of the District Courts and Courts of Appeals,” *Blue Chip Stamps*, 421 U. S., at 730, and endorsed by this Court in *Superintendent of Ins. of N. Y.* v. *Bankers Life & Casualty Co.*, 404 U. S. 6 (1971) .”[28]

The United States Supreme Court has defined securities fraud to include each of the following elements:

> “1. “a material misrepresentation (or omission)”; 2. “scienter, i.e., a wrongful state of mind”; 3. “a connection with the purchase or sale of a security”; 4. “reliance”; 5. “economic loss”; and 6. “loss causation.” See *Dura Pharm., Inc. v. Broudo*, 125 S. Ct. 1627, 1631 (2005) (emphasis removed); see also *Wortley v. Camplin*, 333 F.3d 284, 294 (1st Cir. 2003); *Geffon v. Micrion Corp.*, 249 F.3d 29, 34 (1st Cir. 2001).”

The Oregon Federal Court of Appeal has noted that to prove scienter [mens rea], a plaintiff “must show either that the defendant consciously intended to defraud, or that they acted with a high degree of recklessness.”[29]

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[28] *Merrill Lynch, Pierce, Fenner & Smith, Inc. v Dabit* [2002] U.S. No. 04-1371
395 F. 3d 25

[29] *Aldridge v. A.T. Cross Corp.*, (2002) 284 F.3d 72, 82 (1st Cir. 2002)

Lord Justice Thomas made the following comments about the application of the elements of fraud in a criminal context where securities regulation is concerned. He said:

> "The importance of an effective criminal justice system in deterring fraud and making those who commit it properly accountable for what they have done is beyond question. We do not yet know whether there have been serious financial frauds in the United Kingdom such as those alleged to have been perpetrated by Bernard Madoff or Sir Alan Stanford. As past economic crises have always brought discoveries of serious financial irregularities, it is not the least surprising to read in the last day or so reports that similar serious frauds are being investigated in the City.
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> Although there may be a doubt about the deterrent effect of a properly functioning criminal justice system in relation to some crimes, **I do not think there can be any doubt about it in relation to crime committed in the financial [securities] markets.** There was certainly a strong view, under our old system of regulation and certainly still prevalent in the early 1980s, that the detection and punishment for **false accounting** at the Old Bailey in 1931 of the Chairman of the Royal Mail Steam Packet Company, Lord Kylsant[18] (a leading ship owner, a former MP, holder of a number of honorific positions in Wales), had been considered a very effective deterrent for the ensuing years."[30] [emphasis added]

False accounting has always been the simplest and therefore the most common form of securities fraud. The seminal modern case for the tort of deceit is widely regarded as *Derry v Peek,*[31] whereas the seminal modern case for fraudulent misrepresentation is generally regarded to be *Twycross v Grant.*[32] The criminalization of deceit and fraudulent misrepresentation has been an attempt to deter and punish the perpetrators, but has it been effective? In the United

[30] Thomas L.J. *The Financial Crisis: The Role Of Law And Regulation* The Lord Merlyn-Rees Lecture University of Glamorgan 5 March 2009

[31] *Derry v. Peek* [1889] A.C. 337 (H.L.)

[32] *Twycross v Grant* [1877] 2 C.P.D 469

States the regulators state that their primary function is to recover as much of the money lost in fraudulent transactions[33] as they can. Criminal prosecution for accounting fraud in the United States is relatively rare, thus to determine whether the civil recovery process is effective, one must consider what elements, and remedies are available under the common law, and whether the regulation in place raises or lowers the bar on a common law recovery of losses due to accounting fraud.

ENGLAND: DECEIT AND FRAUDULENT MISREPRESENTATION

The common law tort of deceit was first proscribed by the court of King Henry III in the first decade of the 13th Century as a writ for an action on the case. The description of the original writ of deceit set out in the Natura Brevium is simple, and it is with no small sense of irony that I set out the quote from the Reverend Justice Fitz-Herbert:

> "And if a man play with another at dice, and he have false dice with which he playeth, and get the other's money with these false dice, he who loseth his money may have his action upon the case for this deceit and the form of the writ is such… **contriving deceitfully to defraud**…"[34] [emphasis added]

Stock markets were first described as the world's biggest casinos by John Maynard Keynes.[35] Keynes and many market watchers since, observed that the more complex the security, the less transparent, and therefore the greater the gamble, but the greater the potential return and the greater the level of dishonesty and recklessness. That is…unless you are playing the games with shaved dice.

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[33] Federal Bureau of Investigation, Department of Justice (2010) http://www.fbi.gov/publications/fraud/securities_fraud.htm at 1 August 2010

[34] Fitz-Herbert Anthony R.J. *La Novelle Natura Brevium* 1534 Reprinted 1718 E & R Nutt and A Gosling (assigns of Edward Sayer Esq.) at 950

[35] Bogle, John C., *The Wall Street Casino* The New York Times August 23, 1999

Kiralfy's legal text on tort is an historical treatise which focuses on the evolution of the action on the case[36]. Fraudulent misrepresentation is not identified as a separate action on the case, however, deceit is reviewed at length. What emerges from Kiralfy's review of case material through to 1700 is strong evidence that deceit and fraud have been intertwined from the beginning, and that pleading an action on the case in deceit is, in effect, pleading an action in fraudulent misrepresentation.[37]

Kiralfy suggests that the first recorded case involving deceit and fraudulent misrepresentation that he is able to unearth is a case in which the defendant obtained money from the plaintiff by impersonating the payee and an action on the case was maintained in the form of "falso et fraudulenter''[38]

Kiralfy reviews other cases where deceit or fraud were alleged, but concludes that the breakthrough case for modern law is that of *Bailey v. Merrell* (1615), 3 Bulstr. 95, Cor. Jac.[39] It was described as "the great development of the modern law". In *Bailey*[40] the defendant contracted the plaintiff to draw his goods to market, but misrepresented to the plaintiff the weight of his goods. The plaintiff's draw horses were seriously injured trying to pull the much greater weight. Kiralfy notes that Justice Croke's ruling demarcated the clear need for damage to have been suffered by the claimant, when he said that,

> "damage without fraud gives no cause of action; but where these two do concur and meet together there an action lieth".[41]

Kiralfy concludes by citing *Pasley v. Freeman* (1789), 3 T.R. 51, wherein Grose J. relies on the rule from *Bailey* and states:

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[36] Kiralfy, A..K., The Action on the Case Oxford University Press p. 82
[37] Ibid.
[38] *Thompson v. Gardner* (1597), Moo. 538; Kiralfy, A..K., The Action on the Case Oxford University Press p. 82
[39] Kiralfy, A.K. at 82
[40] *Bailey v. Merrell* (1615), 3 Bulstr. 95, Cor. Jac
[41] Ibid. at 231

> "this is an action against the defendant for making a false affirmation, or telling a lie, respecting the credit of a third person, with intent to deceive, by which the third person was damnified; … the tort complained of is the false affirmation made with intent to deceive; and it is said to be **an action upon the case analogous to the old writ of deceit**"[42] [emphasis added].

Kiralfy oulines several examples demonstrating that an action in deceit has been historically accepted as an action on the case and that the concept of fraud was a necessary component in the cause of an action of deceit.

It is generally accepted that the seminal modern case on the tort of deceit is *Derry v. Peek*[43]. In his opening remarks, Lord Halsbury L.C. said:

> "My Lords, I have so recently expressed an opinion in the Court of Appeal on the subject of actions of this character that I do not think it necessary to do more than say that I adhere to what I there said. To quote the language now some centuries old in dealing with actions of this character, **"fraud without damage or damage without fraud"** does not give rise to such actions. I have had also the opportunity of reading the judgment of my noble and learned friend Lord Herschell, and I could desire to add nothing to his exhaustive and lucid treatment of the authorities."

Lord Hershell did a comprehensive review of deceit cases, which necessarily included an element of fraudulent misrepresentation, decided in the United Kingdom over the previous one hundred years, and helpfully distinguished between an action in deceit and an action for fraudulent misrepresentation, relying on the statement of Cotton LJ:

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42 *Pasley v. Freeman* (1789), 3 T.R. 51
43 *Derry v. Peek* [1889] A.C. 337 (H.L.)

> "This action is one which is commonly called an action of deceit, a mere common law action."[44]

He continued with the distinction:

> "I think it important that it should be borne in mind that such an action differs essentially from one brought to obtain rescission of a contract on the ground of misrepresentation of a material fact. The principles which govern the two actions differ widely. Where rescission is claimed it is only necessary to prove that there was misrepresentation; then, however honestly it may have been made, however free from blame the person who made it, the contract, having been obtained by misrepresentation, cannot stand. In an action of deceit, on the contrary, it is **not enough to establish misrepresentation alone**; it is conceded on all hands that something more must be proved to cast liability upon the defendant, though it has been a matter of controversy what additional elements are requisite."[45] [emphasis added]

Lord Herschell summarized the added elements (supra.) of the tort of deceit as follows:

> "First, in order to sustain an action of deceit, there must be proof of fraud [dishonesty], and nothing short of that will suffice. Secondly, fraud is proved when it is shown that a false representation has been made (i) knowingly, or (ii) without belief in its truth, or (iii) recklessly, careless whether it be true or false. … Thirdly, if fraud be proved, the motive of the persons guilty of it is immaterial. It matters not that there was no

[44] *Derry v. Peek* [1889] A.C. 337 (H.L.) at 131
[45] Ibid.

> intention to cheat or injure the person to whom the statement was made."[46]

Lord Herschell's definition is something of a tautology insofar as the words fraud, deceit, dishonesty, false representation, fraudulent misrepresentation, and fraudulent representation, are used interchangeably.[47] However, it is clear that an action in deceit cannot succeed unless there is proof of fraud consisting of a false representation, which can arise in one of three ways, namely knowingly, recklessly, or without due care to ensure the truth of the statement made.

The distinction between deceit and fraudulent misrepresentation are important because the damages for the latter are limited to rescission. In the earlier case of *Twycross v Grant*,[48] Cockburn CJ, in relation to a fraudulent misrepresentation claim first lodged in the Court of Common Pleas, illustrates that the tort of deceit set out in *Derry v Peek* for a false prospectus, can also be stated as a contractual breach claim:

> "His grievance is not that he has paid too high a price, but that he has been induced to take shares which, but for the fraud, he would not have taken at all. He is, therefore, in the position of a person who has been induced to take shares and pay the price of them by a fraudulent misrepresentation, and he is, therefore, entitled to recover such damages as have resulted to him from taking such shares. If this damage extends to the entire price paid for the shares he is entitled to recover it."[49]

In respect of the calculation of damages, Cockburn C.J set out the following proposition:

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[46] Ibid. at 45
[47] *Perry, Farley & Onyschuk v. Outerbridge Management Ltd*, [2001] 5678 ON C.A.; 199 D.L.R. (4th) 279 per Sharpe JA at 21-25
[48] *Twycross v Grant* [1877] 2 C.P.D 469
[49] *Ibid.* at 543

> "A party who has been induced by fraudulent misrepresentation to purchase a given article, unless he rescinds the contract and returns the thing bought, which in such a case as the present it is admitted that the plaintiff is not in a position to do, can only recover damages to the extent of the loss he has actually sustained. He can not recover the entire price he has paid, unless the thing prove wholly worthless. If the thing has any appreciable value, the damages must be reduced pro tante."[50]

The Chancery Court and the Court of Common Pleas are shown to have reached similar conclusions on the application of the elements of deceit and fraudulent misrepresentation, but the Chancery Court, as a court of equity could go further in compensating the injured party. The Court of Common Pleas, now better known as the Commercial Court, would ordinarily be restricted to a order for damages attendant to the fraudulent misrepresentation, namely the difference in price between the value of the property at the time the acquisition was induced, and the value at the time the claim was lodged, or if the current value is zero, potentially a rescission of the contract in its entirety.

AUSTRALIA

The seminal High Court fraudulent misrepresentation case came about in 1907.[51] O'Connor J. set out the rule articulated by Chief Justice Griffith, as the same rule which had been adopted by the United State Supreme Court in *Marshall v Hubbard* [1886] USSC 99; 6 S.Ct. 80. Griffiths C. J. speaking on behalf of the High Court, stated:

> "It was said in that case by the Judge in summing up to the jury, and the statement was afterwards approved by the Supreme Court of the United States:— "But there are certain other elements of fact which necessarily enter into this defence. Not only must the representations be made, not only must they be

[50] *Twycross v Grant* [1877] 2 C.P.D 469 at 543
51 *Holmes v Jones* [1907] HCA 35; (1907) 4 CLR 1692

> fraudulent, and not only must it appear that the party relied, and had a right to rely, upon them, but it must also be shown that the representations were material to the contract or transactions which took place between the parties; and, further, that injury has been sustained, damage has resulted to the defendant from the alleged fraudulent representations." That states the law in exactly the same way as it is laid down in the cases cited by my learned brother the Chief Justice."[52]

Chief Justice Griffith, although deciding that the Defendant Directors had not perpetrated a fraudulent misrepresentation, set out the rule for assessing damages for losses which might be incurred as a result of a misrepresentation made in a prospectus:

> "The true rule, as I understand it, was laid down by *Buckley* J. in the case referred to by my learned brother *Isaacs, Broome v. Speak,* which was an action against directors of a company, claiming damages for fraudulent misrepresentation in a prospectus. The learned Judge there said:—"The result of this is that the plaintiff is entitled to damages as against all the defendants. The measure of damages is well fixed. It is the difference between the price which the plaintiff paid for the thing, and the fair value of the thing at the date at which he got it." That case went on to the Court of Appeal, and further to the House of Lords under the name *Shepheard v. Broome*, and was there affirmed."[53]

Griffith CJ went on to set out in detail the Australian position on the rule for the breach of contract action of fraudulent misrepresentation:

> "And *Thesiger* L.J., after referring to *Twycross v. Grant* in which the same rule had been laid down, referred to *Davidson v. Tulloch* as authority for the proposition that "the proper mode of measuring the damages is to ascertain the difference between the purchase-money and what would have been a fair price to be paid for the article

[52] *Holmes v Jones* [1907] HCA 35; (1907) 4 CLR 1692 p. 9
[53] Ibid. p. 6

> at the time of the purchase." That, I conceive, is the English rule of law, and any other rule would lead to the most extraordinary consequences. Suppose that a man was induced by fraudulent misrepresentation to give £10,000 for a property worth £20,000, on a representation that it was worth £30,000. If the law were as the plaintiffs contend the purchaser would be entitled to recover from the vendor the whole of the purchase money, and have a property worth £20,000 for nothing, and would get that as compensation for the injury done him by the defendant."

Potts v Miller is one of the first cases where the High Court considered the conflation of the torts of deceit and the breach of contract action, fraudulent misrepresentation.[54]

> "… but a question arose whether the defendant deliberately misstated the obligation he had undertaken in order to influence the plaintiff's judgment and, if so, whether so much of the defendant's statement as exceeded the truth formed an operative inducement to the plaintiff. It appears to me that the circumstances were such as to place a heavy burden on the plaintiff in satisfying the jury upon these questions. To begin with the plaintiff had in both earlier proceedings alleged a different form of representation. Then it was necessary to be sure that before 25th March more than one other signature besides the defendant's had been placed upon the document of 24th March ; and next that the defendant understood and, as he spoke, had in mind the true effect of the proportionate limitation of the responsibility of the signatories. Further, as the statement was made in answer to a question, some doubt might well exist whether it was intended as an inducement. Last, the plaintiff's reliance on so much of the statement as conflicts with the facts is open to serious question. For, in the course of the case, strong evidence was given that the plaintiff was induced to subscribe for his shares by much more cogent considerations than a belief that the defendant had undertaken a responsibility for 4,500 as opposed to 1,285 shares in the company. It is true that, if the representation be treated as continuing or as repeated, it became untrue on 12th April when the remaining 5,000 shares were underwritten.

54 *Gould v Vaggelas* [1985] HCA 85; (1984) 157 CLR 215

> But if the fraud were based upon this view, further findings of fact would have been necessary. Upon all the foregoing matters, the proofs offered lacked precision and no very exact investigation was made. The charge to the jury did not call their pointed attention to the difficulties in the way of a finding for the plaintiff. The actual finding of inducement combined both representations together as a basis for the plaintiff's action.

Defined at s408C[55] of the Queensland Criminal Code, a crime of fraud is committed when the property of another has been obtained through dishonesty.[56] The majority of the High Court stated that the Jury must be "satisfied beyond reasonable doubt as to **the knowledge, belief or intent** alleged by the prosecution."[57] [emphasis added]

CANADA

The Ontario Court of Appeal in the Bre-X case sets out the history of the tort of deceit, fraudulent misrepresentation, and negligent misrepresentation[58] as they have been incorporated into Canadian law:

> The constituent elements of a claim for fraudulent misrepresentation were enunciated by the Supreme Court of Canada in *Parna v. G. & S. Properties Ltd.* (1970), 15 D.L.R. (3d) 336 (S.C.C.) at 344.

The court notes that the constituent elements of fraud are:

> [Fraud is] a false representation of fact, made with a knowledge of its falsehood, or recklessly, without belief in its truth, with the

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[55] Criminal Code 1889 (QLD); The same language is employed at s 178A of the *Crimes Act 1900* (NSW);
[56] Peters v R (1998) 192 CLR 493
[57] Ibid. at 59
[58] *Carom v Bre-X Minerals Ltd*., [2000] 196 D.L.R. (4th) 344

intention that it should be acted upon by the complaining party, and actually inducing him to act upon it.

See also *Derry v. Peek* (1889), 14 A.C. 337 (H.L.) at 374.

The tort of negligent misrepresentation has five constituent elements. There must be a duty of care arising from a special relationship between a representator and a representee. There must be a representation made that was untrue, inaccurate or misleading. The representor must have made the statement negligently. The representee must have reasonably relied upon the statement and further, suffered damages as a result of the reliance. See *Queen v. Cognos* [1993] 1 S.C.R. 87 at 110."

In the Ontario Court of Appeal, in obiter, noted there are substantial similarities in the definitions of fraudulent misrepresentation and negligent misrepresentation. It was observed that a fraudulent misrepresentation is "a false representation of fact"[59], and a negligent misrepresentation is a representation of fact that is "untrue, inaccurate or misleading"[60]. A fraudulent misrepresentation can be one that is made "recklessly, without belief in its truth"[61] whereas a negligent misrepresentation is one that is made "negligently". Stated another way, negligent misrepresentation can be described as a representation of fact that is made "carelessly"[62].

Of particular significance is Sharpe J.A.'s comment that the action for deceit was developed as an action on the case.

"Derry v Peek was first relied upon by the Supreme Court of Canada in *Parna v. G. & S. Properties Ltd.*, 1970 CanLII 25 (S.C.C.), [1971] S.C.R. 306. This case concerned a

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59 *Carom v Bre-X Minerals Ltd*., [2000] 196 D.L.R. (4th) 344
60 Ibid.
61 Ibid.
62 Ibid.

claim against a vendor of an apartment building who allegedly made fraudulent misrepresentations about the operating costs of the building. One of the reasons given for dismissing the plaintiffs' appeal was that they had “failed to prove false representation of fact made with a knowledge to its falsehood or recklessly, without belief in its truth…” in conformity with Lord Herschell’s statement in *Derry* that “**in order to sustain an action in deceit there must be proof of fraud, and nothing short of that will suffice**…”.

More recently, in *Duong v. NN Life Insurance Co. of Canada*, [1999] O.J. No. 2680 (S.C.J.), Sedgwick J. recited, with approval, Lord Herschell’s legal elements (para 14). Sedgwick J. also referred to the legal elements as “the legal elements of the tort of deceit or fraudulent misrepresentation”. In *3218520 Canada Inc. v. Bre-X Minerals Ltd. et al.* 2000 CanLII 16886 (ON C.A.), (2000), 51 O.R. (3d) 236 (C.A.), the Court of Appeal cited *Parna* as authority for the elements of fraudulent misrepresentation, along with *Derr*y (para 43). In *Rosenich v. Welke*, [2003] A.J. No. 1337 (Alberta, Court of Queen's Bench), Sirrs J. stated (at para. 35) that "for there to be fraudulent misrepresentation, there must be deceit" and (at para. 37) "… **being liable for fraudulent misrepresentation or the tort of deceit is one of the same."**[63] [emphasis added]

In Canada, the courts have applied the tort of deceit and an action for fraudulent misrepresentation as conflating into virtually convertible actions with different remedies.

Fraud, which is more accurately described as fraudulent misrepresentation, is included as an element of the tort known as deceit; however fraudulent misrepresentation is cause of action which sounds in contract law. Canadian Courts (supra.) have tended to treat the two causes of action similarly without a major difference in the remedies made available to victims. The tort

[63] ***Re*** *Bozzo (Bankruptcy)* [2005] ON S.C. CanLII 17919

of deceit has a range of damages available to the claimant under the common law, but an action for fraudulent misrepresentation in breach of the express or implied terms of a contract would only permit a rescission of the contract in the United Kingdom, but in Canada the courts will be open to treat the remedies in the same way as deceit.

UNITED STATES:

In the United States the essential elements of fraud and deceit were set out by the United States Supreme Court in *Marshall v Hubbard*:

> "But there are certain other elements of fact which necessarily enter into this defense. Not only must the representations be made, not only must they be fraudulent, and not only must it appear that the party relied, and had a right to rely, upon them, but it must also be shown that the representations were material to the contract or transaction which took place between the parties, and further that injury has been sustained, damage has resulted to the defendant from the alleged fraudulent representations. These are as essential as any of the other elements of fact which must be shown in establishing such a defense. I repeat that it must appear that the defendant has sustained damages which are chargeable to the alleged fraudulent representations, and for which therefore the plaintiff is legally responsible..."[64]

Conduct may constitute fraud because of an intentional misrepresentation, concealment, a false promise or a negligent misrepresentation.

A deceit is either:

1. The suggestion, as a fact, of that which is not true, by one who does not believe it to be true;

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[64] *Marshall v Hubbard* 117 U. S. 415 (1886)

2. The assertion, as a fact, of that which is not true, by one who has no reasonable ground for believing it to be true;
3. The suppression of a fact, by one who is bound to disclose it, or who gives information of other facts which are likely to mislead for want of communication of that fact; or,
4. A promise, made without any intention of performing it.[65]

The essential elements of a claim of fraud by an intentional misrepresentation are:

1. The defendant must have made a representation as to a past or existing material fact;
2. The representation must have been false;
3. The defendant must have known that the representation was false when made or must have made the representation recklessly without knowing whether it was true or false;
4. The defendant must have made the representation with an intent to defraud the plaintiff, that is, he she must have made the representation for the purpose of inducing the plaintiff to rely upon it and to act or to refrain from acting in reliance thereon;
5. The plaintiff must have been unaware of the falsity of the representation; must have acted in reliance upon the truth of the representation and must have been justified in relying upon the representation;
6. And, finally, as a result of the reliance upon the truth of the representation, the plaintiff must have sustained damage.[66]

Ordinarily, expressions of opinion are not treated as representations of fact upon which to base actionable fraud. However, when one party possesses or holds himself out as possessing superior knowledge or special information regarding the subject of a representation, and the other party is so situated that he or she may reasonably rely upon such supposed superior

[65] Cal.Civ.Code § 1710
[66] *Stansfield v. Starkey* (1990) 220 Cal.App.3d 59; Cal.Civ.Code § 1572

knowledge or special information, a representation made by the party possessing or holding himself out as possessing such knowledge or information will be treated as a representation of fact although if made by any other person it might be regarded as an expression of opinion.[67] When a party states an opinion as a fact, in such a manner that it is reasonable to rely and act upon it as a fact, it may be treated as a representation of fact.

Concealment is a term of art which includes mere nondisclosure when a party has a duty to disclose.[68]

The essential elements of a claim of fraud by concealment are:

1. The defendant must have concealed or suppressed a material fact;
2. The defendant must have been under a duty to disclose the fact to the plaintiff;
3. The defendant must have intentionally concealed or suppressed the fact with the intent to defraud the plaintiff;
4. The plaintiff must have been unaware of the fact and would not have acted as he or she did if he or she had known of the concealed or suppressed fact; and,
5. Finally, the concealment or suppression of the fact caused the plaintiff to sustain damage.[69]

Where material facts are known to one party and not to the other, failure to disclose them is not actionable fraud unless there is some relationship between the parties which gives rise to a duty to disclose such known facts.[70]

A duty to disclose known facts arises where the party having knowledge of the facts is in a fiduciary or a confidential relationship. A fiduciary or a confidential relationship exists

[67] Ibid.
[68] *Lingsch v. Savage* (1963) 213 Cal.App.2d 729, 738; Rest.2d Torts, § 551
[69] Ibid.
[70] Rest.2d Torts, § 551

whenever under the circumstances trust and confidence reasonably may be and is reposed by one person in the integrity and fidelity of another.[71]

A duty to disclose known facts arises in the absence of a fiduciary or a confidential relationship where one party knows of material facts and also knows that such facts are neither known nor readily accessible to the other party.[72]

Failure to disclose a negative fact where it will have a foreseeably depressing effect on income expected to be generated by a business is tortious.[73]

Intentional concealment exists where a party:

1. Knows of defects in a property and intentionally conceals them, or
2. Actively prevents investigation and discovery of material facts by the other party, or
3. While under no duty to speak, nevertheless does so, but does not speak honestly or makes misleading statements or suppresses facts which materially qualify those stated.[74]

The essential elements of a claim of fraud by a false promise are:

1. The defendant must have made a promise as to a material matter and, at the time it was made, he or she must have intended not to perform it;
2. The defendant must have made the promise with an intent to defraud the plaintiff, that is, he or she must have made the promise for the purpose of inducing plaintiff to rely upon it and to act or refrain from acting in reliance upon it;

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[71] Ibid.
[72] Ibid.
[73] Rest.2d Torts, § 551, illus. 11
[74] Rest.2d Torts, § 551, illus. 11

3. The plaintiff must have been unaware of the defendant's intention not to perform the promise; he or she must have acted in reliance upon the promise and must have been justified in relying upon the promise made by the defendant; and
4. As a result of reliance upon defendant's promise, the plaintiff must have sustained damage.[75]

The conduct of a party making a promise, either before or after the promise was made, may be taken into consideration in determining whether there was an intention not to perform the promise when made.

The essential elements of a claim of fraud by a negligent misrepresentation are:

1. The defendant must have made a representation as to a past or existing material fact;
2. The representation must have been untrue;
3. Regardless of his or her actual belief the defendant must have made the representation without any reasonable ground for believing it to be true;
4. The representation must have been made with the intent to induce plaintiff to rely upon it;
5. The plaintiff must have been unaware of the falsity of the representation; must have acted in reliance upon the truth of the representation and must have been justified in relying upon the representation; and
6. As a result of the reliance upon the truth of the representation, the plaintiff must have sustained damage.[76]

The misrepresentation or false promise or concealment must have been made or done with the intent to induce some person or persons to act in reliance upon it and the party making the representation or promise is liable only to those persons to whom the representation or promise

[75] Ibid.
[76] *Gagne v. Bertran* (1954) 43 C.2d 481; *Hedley Byrne v. Heller & Partners Ltd*[1964] AC 465; [1963] 2 All ER 575

has been made from whom a material fact was concealed with such intent. If others become aware of the representation or promise or are misled by the concealment and act upon such, there is no liability.[77]

One who makes a misrepresentation or false promise or conceals a material fact is subject to liability if he or she intends or has reason to expect that the misrepresentation or false promise concealment of material fact will be passed on to another person and influence such person's conduct in the type of transaction involved.[78]

A person has reason to expect that a misrepresentation, false promise or nondisclosure of material fact will be passed on to other persons and influence that person's conduct if he or she has information that would lead a reasonable person to conclude that there is a likelihood that it will reach such persons and will influence them or their conduct in the type of transaction involved. Subject to liability means that the defendant is liable if all of the other essential elements of the claim of fraud are established. [79]

One who makes a misrepresentation or false promise or conceals a material fact with the intent to defraud the public or a particular class of persons is deemed to have intended to defraud every individual in that category who is actually misled thereby.[80]

A party claiming to have been defrauded by a false representation or promise must have relied upon the representation or promise; that is, the representation or promise must have been a cause of plaintiff's conduct in entering into the transaction and without such representation or promise plaintiff would not have entered into such transaction.
The fraud, if any, need not be the sole cause if it appears that reliance upon the representation or promise substantially influenced such party's action, even though other influences operated as well.[81]

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[77] Ibid.
[78] Ibid.
[79] Ibid.
[80] *Carpenter v. Hamilton* (1936) 18 Cal.App.2d 69, 75

A party claiming to have been defrauded by a false representation or promise must not only have acted in reliance on it but must have been justified in such reliance, that is, the situation must have been such as to make it reasonable in the light of the circumstances and plaintiff's intelligence, experience and knowledge, to accept the representation or promise without making an independent inquiry or investigation.[82]

If a party claiming to have been defrauded makes an independent investigation of the subject matter of the alleged false representation or promise and the decision to engage in the transaction is the result of his or her independent investigation and not his or her reliance upon the representation or promise, he or he is not entitled to recover.[83]

SECURITIES FRAUD

There are at least sixteen recognized varieties of securities fraud, including: 1. High Yield Investment Fraud;[84] 2. Ponzi Schemes;[85] 3. Pyramid (Affinity) Schemes;[86] 4. Advanced Fee Schemes;[87] 5. Foreign Currency Fraud;[88] 6. Broker Embezzlement or Front-running Schemes;[89] 7. Hedge Fund Related Fraud;[90] 8. Late Day Trading;[91] 9. Microcap/Chop-Stock

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[81] Ibid.
[82] Ibid.
[83] *Carpenter v. Hamilton* (1936) 18 Cal.App.2d 69, 77
[84] *United States Of America v E-Gold,* Ltd Columbia District Court [2008] U.S. Dist. LEXIS 37602
[85] *Retirement Program for Employees of Town of Fairfield et al. v Madoff et al.* [2010] Superior Court of Connecticut, Judicial District of Stamford-Norwalk, Not Reported in A.2d, 2010 WL 2106654 C Conn.Super.,2010
[86] *United States v Randall T. Treadwell* (2010) 593 F.3d 990, 10 Cal. Daily Op. Serv. 1201, 2010 Daily Journal D.A.R. 1593, 9th Cir.(Cal.),
[87] *United States v Olivia Jeanne Bowen* (2010) 689 F.Supp.2d 675 S.D.N.Y.
[88] *United States v Jeffrey Ferdinand Block* (2005) 148 Fed.Appx. 904 C.A.11 (Fla.)
[89] *United States v Robert Mahaffy* (2007) 477 F.Supp.2d 560 E.D.N.Y.
[90] *Securities and Exchange Commission v Oversea Chinese Fund Limited* (2009) WL 5075467 United States District Court, N.D. Texas
[91] *Securities Exchange Commission v Pentagon Capital Management PLC* (2010) F.Supp.2d; WL 2670843, S.D.N.Y.

("pump and dump") Fraud;[92] 10. Derivative Fraud (misleading disclosure);[93] 11. Holding Company-Subsidiary Fraud; 12. Unlicensed Broker Fraud;[94] 13. Unregistered Securities Fraud;[95] 14. Online Trading Fraud; [96] 15. Insider Trading;[97] and, 16. Accounting Fraud.[98] While there is scope to study the relationship between each of these types of securities frauds, and accounting fraud, this paper does not permit the enquiry to extend to that level of detail.

The US Supreme Court has elegantly summarized the interrelationship between the Securities Act 1933, the Securities Exchange Act 1934, and the rules promulgated under delegated authority by dint of the latter enactment:

> " Section 10(b) of the Securities Exchange Act makes it "unlawful for any person . . . [t]o use or employ, in connection with the purchase or sale of any security . . ., any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe." 15 U.S.C. § 78j.
>
> Pursuant to this provision, the SEC has promulgated Rule 10b—5. That Rule forbids the use, "in connection with the purchase or sale of any security," of (1) "any device, scheme, or artifice to defraud"; (2) "any untrue statement of a material fact"; (3) the omission of "a material fact necessary in order to make the statements made . . . not

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92 *Securities Exchange Commission v China Energy Saving Technology, Inc.* (2009) 636 F.Supp.2d 199, E.D.N.Y., Jul 06, 2009

93 *Larry Freudenberg v E*Trade Financial Corp.* (2010) F.Supp.2d, WL 1904314, Fed. Sec. L. Rep. P 95,743, S.D.N.Y.,

94 *State of Utah v State v Joseph Candedo* (2010) 232 P.3d 1008 Utah

95 *Robert Morrison v. National Australia Bank Ltd.* (2010) 130 S.Ct. 2869, 78 USLW 4700, Fed. Sec. L. Rep. P 95,776, 10 Cal. Daily Op. Serv. 7918, 2010 Daily Journal D.A.R. 9676

96 *Commodity Futures Trading Commission v Donald Steven Smith (*2004) Not Reported in F.Supp.2d, 2004 WL 2203488, Comm. Fut. L. Rep. P 29,834, C.D.Cal.

97 *Samuelson Trading Corp. v Waksal (ImClone case*) [2004] Not Reported in F.Supp.2d, 2004 WL 813534 N.D.Ill.

98 *Jeffrey K. Skilling v United States* [2010] 130 S.Ct. 2896

> misleading"; or (4) any other "act, practice, or course of business" that "operates . . . as a fraud or deceit." 17 CFR §§240.10b—5 (2000).
>
> To succeed in a Rule 10b—5 suit, a private plaintiff must show that the defendant used, in connection with the purchase or sale of a security, one of the four kinds of manipulative or deceptive devices to which the Rule refers, and must also satisfy certain other requirements not at issue here. See, *e.g.*, 15 U.S.C. § 78j (requiring the "use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange"); *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 193 (1976) (requiring scienter, meaning "intent to deceive, manipulate, or defraud"); *Basic Inc.* v. *Levinson*, 485 U.S. 224, 231—232 (1988) (requiring that any misrepresentation be material); *id.*, at 243 (requiring that the plaintiff sustain damages through reliance on the misrepresentation)."[99]

ACCOUNTING FRAUD

It has already been well established that securities laws prohibit the use of fraudulent activities in connection with the offer, purchase or sale of securities. The Securities and Exchange Commission say they endeavor to regulate securities fraud, and in particular accounting fraud. States also regulate securities fraud through individual state Securities Commissioners and state securities laws known as "Blue Sky Laws." Securities fraud may be committed by brokers, financial advisors or analysts, corporations or private investors.

The majority of securities fraud cases in the United States involve misrepresentations as defined in s 10b and Rule 10b-5 of the *Securities Exchange Act 1934*. Section 10b is a general provision that prohibits any person from using fraud in connection with the purchase or sale of

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[99] *Wharf (Holdings) Ltd. v United Int'l Holdings, Inc***.** 532 U.S. 588 (2001)

any security. Rule 10b-5, which flows from s 10b, specifically prohibits making any false statements or omissions in connection with the sale or purchase of securities.

A "false statement" is defined as any statement that misleads or creates a false impression. To be actionable under Rule 10b-5, the false statement, either by commission or omission, must be material.[100] A statement is material if it would be important to a reasonable investor making an investment decision.[101] Additionally, the statement or omission must be made with the intent or intention to deceive, manipulate or defraud. Thus, reasonable mistakes of fact, made without a malicious intent, are not actionable under Rule 10b-5.

Misrepresentations are frequently made by corporations who conceal or distort their financial information, by overstating or misstating revenues or assets, and underreporting liabilities, thereby tricking investors into believing the corporation is more profitable than is reflected in the underlying business. Misrepresentation of financial information by corporations is classified as accounting fraud. As a result of several major accounting scandals, the government enacted the *Sarbanes-Oxley Act of 2002*, which imposes a number of securities law reforms aimed at increasing financial disclosures and discouraging this type of securities fraud. As stated previously, is the prosecution of the Dell Inc case indicative of a proper application of the law by the SEC?

The largest accounting fraud of all time is Worldcom.[102] Worldcom agreed to pay the SEC the largest penalty in history, namely US$2.2 billion, but that sum was never in fact paid because Worldcom had already filed for Chaper 11 bankruptcy protection when it announced that it would have to restate earnings for 5 quarters. The Founder and CEO, Bernie Ebbers, is in prison, convicted for criminal fraud in connection with the misstatement of the financial position of Worldcom in its financial statements. In percentage terms the accounting

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[100] *United States v Jerry Wells and Kenneth R Steele* (1997) (95-1228), 519 U.S. 482
[101] Ibid.
[102] *In re WorldCom, Inc*. Sec. Lit., 308 F.Supp.2d 236, 248 (S.D.N.Y.2004)

misrepresentations perpetrated by Worldcom are not dissimilar in magnitude to that perpetrated by Dell Inc in 2006.

However, the Author will briefly introduce the accounting frauds perpetrated by Enron, Nortel, and Lehman Brothers. These are three recent, significant examples of accounting fraud. Nortel Networks Limited was the publicly traded research arm of Bell Telephones. Until its bankruptcy it was the largest telecommunications research and development company in the world. Enron, the one-time oil and gas pipeline operator, vaunted for its innovative energy trading schemes, is also defunct, and the blame can be largely laid at the feet of accounting fraud. The widely accepted catalyst for the Global Financial Crisis, Lehman Brothers Limited,[103] is the last example cited. It provides little assistance in comparing the Dell Inc settlement agreement of two weeks ago, but it does highlight the likely outcome of a multi-billion dollar accounting fraud, namely the destruction of the company.

The purpose of highlighting the SEC's response to companies other than Dell Inc, is to draw attention to certain legislative and regulatory deficiencies in the securities regulatory regime in the United States, even after President Obama signed in to law the *Dodd-Frank Wall Street Reform and Consumer Protection Act 2010.*

EXAMPLES OF ACCOUNTING FRAUD

I. ENRON: In the Enron accounting fraud example, a number of the off-balance sheet financings designed to give the false appearance of a profit, were structured by CIBC Capital Markets, a subsidiary of the Canadian Imperial Bank of Commerce, one of five major banks in Canada. The financings were in fact monies borrowed by special purpose vehicles orphaned from the Enron balance sheet, and held personally by Andrew Fastow,[104] the then

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[103] *Wall Street Journal*, Wednesday, September 17, 2008, Front Page

[104] *Securities and Exchange Commission v Canadian Imperial Bank Of Commerce, Daniel Ferguson, Ian Schottlaender, Mark Wolf* [2003] United States District Court
Southern District of Texas, Houston Division H03-5785
http://www.sec.gov/litigation/complaints/comp18517.htm

Chief Financial Officer of Enron. The monies borrowed through these orphaned SPV's were injected in to Enron as either operating revenue or a capital gain; with some monies used to support the price of Enron stock.

The SEC brought a complaint against the Canadian Imperial Bank of Commerce and a number of its employees for aiding and abetting an accounting fraud. The SEC complaint against the bank is informative:

> "As set forth above, defendants knew, or were reckless in not knowing, that the transactions were **sham asset sales** designed solely to improve Enron's financial picture. Defendants knew, or were reckless in not knowing, that the purpose of the sham financings was to obtain sale treatment for the assets so as to book an accounting gain, generally by the end of a reporting period, and to keep debt off Enron's balance sheet. [emphasis added]
>
> From the beginning of their relationship with Enron, defendants knew they were dealing with an entity whose reported financial results were dependent on accounting gains, rather than earnings from operations. [CIBC's] knowledge was not obtained from reviewing Enron's financial reports, but from Enron itself, and Enron made clear that CIBC was to keep such information confidential. For example, in December 1998, a senior CIBC official expressed concern within CIBC over the amount of "financially engineered" earnings recognized by Enron from financing transactions and inquired as to how much of Enron's earnings were "real," i.e., derived from commercial operating activities. Schottlaender responded to the inquiry by stating that approximately one-fifth of Enron's reported earnings in 1998 "was from various accounting gains." Schottlaender also noted that "Enron has asked that we keep the following information confidential as they consider it very `sensitive.'"[105]

[105] Ibid.

Two of Enron's credit applications to CIBC Capital Markets memorialized the accounting fraud aspect of Enron's financing objectives:

> *Riverside Credit Application, June 1998* - The "underlying purpose ... is to enable Enron to book a 2nd quarter accounting gain," and given Enron's "accounting objectives Enron needs to sign this facility by 26 June."[106]
>
> *Riverside Credit Application, September 1998* - The financing "helps achieve one of [Enron's] quarterly financial objectives," and to secure this "accounting gain" the financing needed to close by September 30.[107]
>
> *Pilgrim Credit Application, December 1998* - "these transactions will be structured to provide Enron with off-balance sheet financing and will also provide Enron with an accounting gain." The financing provided "a profitable opportunity for CIBC" and was "very important to the Company and our relationship with them."[108]

The SEC settled its claim against the Canadian Imperial Bank of Commerce ("CIBC") in where the CIBC agreed to pay a settlement totaling US$80 million and its employees paying another US$ 600 thousand.[109] The settlement sets out the acknowledgement by CIBC of its role in a number of the Enron accounting frauds. A Press Release issued by the SEC at the time of reaching agreement with CIBC sets out the following:

> "Between June 1998 and October 2001, CIBC and Enron structured 34 financings as "asset sales" for accounting and financial reporting purposes,

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106 Ibid.
107 Ibid.
108 Ibid.
109 Securities Exchange Commission, *CIBC to Pay $80 Million, Executives to Pay More than $600,000, to Compensate Fraud Victims* 22 December 2003 Press Release 2003-180, Washington D.C.

> allowing Enron to hide from investors and rating agencies the true extent of its borrowings. Enron used these disguised loans to increase earnings by more than $1 billion, to increase operating cash flows by almost $2 billion, and to avoid disclosure of more than $2.6 billion in debt on its financial statements. Enron's alternative, borrowing money using the asset as collateral, would have given Enron access to cash to meet its operating expenses, but carried with it financial reporting consequences — increased debt, no positive effect on cash flow and no positive effect on earnings — that would have had a detrimental impact on Enron's credit rating and stock price.
>
> As alleged in the Commission's complaint, the financings involved purported transfers of assets from Enron to Enron-sponsored off-balance sheet qualified special purpose entities (QSPEs) or special purpose entities (SPEs). Enron treated these transfers as accounting "sales" pursuant to Financial Accounting Standards Board (FASB) Statements No. 125 and 140, in order to book earnings and recognize operating cash flows, without reporting the associated debt on its financial statements. CIBC organized a syndicate of banks to provide, in the form of debt, the majority of the capitalization of the QSPEs and SPEs. Applicable accounting rules also require that a portion of their capitalization — nominal in the case of a QSPE and at least three percent in the case of an SPE — be equity unrelated to Enron and at risk of loss. CIBC provided this outside "equity at risk" to validate the financings. The accounting rules also require that the transferor, Enron, relinquish control over the assets, transferring the risk and rewards of ownership of the assets to the transferees."[110]

There is little that can be added to the admission by the CIBC of its role in the Enron accounting fraud. Neither can one amplify or diminish the artifice and deceit that was employed by Enron to show a financial result to the market that was significantly removed from the truth. This was

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[110] Ibid.

criminal fraud as defined in the relevant enactments, but was also common law deceit, fraudulent misrepresentation.

II. NORTEL NETWORKS: The case by the SEC against Nortel Networks was recently settled with a modest one-time payment of US$ 35million, along with certain changes to accounting procedures, as compensation for a US$ 1.2 billion accounting fraud.[111] The SEC have not filed criminal fraud charges against Frank Dunn, the former CEO of Nortel; neither have they filed criminal fraud charges against any of the other executives or directors of Nortel. The Royal Canadian Mounted Police have filed criminal fraud charges in Ontario, Canada, but the criminal case has not yet gone to court. The SEC complaint filed against Nortel in the Massachusetts District Court outlines two separate forms of accounting fraud. The SEC described the first alleged accounting fraud as follows:

> "Nortel banned the use of such [bill and hold] transactions company-wide, but, after Nortel's revenues fell short of expectations in the third quarter of 2000, Dunn, Beatty and Pahapill reintroduced bill and hold transactions into the Company's sales and accounting practices. This change principally affected the reporting of revenues on Nortel's optical business – a metric closely watched by Wall Street – by enabling Nortel to recognize revenues on idle, undelivered inventory sitting in its warehouses and offsite storage locations. The transactions did not satisfy US GAAP requirements, but, Nortel nonetheless recognized revenues as if they did."

The second form of alleged accounting fraud is set out as follows:

> "When fiscal year 2003 turned out to be rockier than expected, Dunn, Beatty and Gollogly orchestrated the improper release of sufficient excess reserves to cause Nortel to report a profit in the first quarter of 2003, a quarter earlier than the public expected, and to pay defendants and others substantial bonuses. Hamilton, Johnson, Kinney and Taylor actively contributed to the result by improperly releasing tens of

[111] SEC

millions of dollars of reserves from the books and records of their respective business units for the first quarter of 2003. In public statements, Dunn falsely attributed Nortel's first quarter 2003 return to profitability to the strength of his business model."

As in the case of CIBC and Enron, the company did not achieve the results it represented to the marketplace. Ironically, at one point Nortel was more profitable than reported, but was later significantly less profitable, with the unexpected profits from a prior period being used to pad the subsequent quarterly results in order to earn bonuses for financial performances that were trending upward. The SEC Press Release acknowledges a settlement with Nortel Networks Inc, in the sum of US$35million[112] paid as a civil penalty in final settlement for what the SEC described as a US$1.4 billion accounting fraud:

> "According to the Commission's complaint, from late 2000 through January 2001, Nortel made changes to its revenue recognition policies that were not in conformity with U.S. Generally Accepted Accounting Principles (GAAP). The changes were made to fraudulently accelerate revenue into 2000 to meet its publicly announced revenue targets for the fourth quarter of 2000 and for that year. The complaint alleges that Nortel also selectively reversed certain revenue entries during the 2000 year-end closing process when its acceleration efforts pulled in more revenue than necessary to meet its targets. These actions, the complaint alleges, inflated Nortel's fourth quarter and fiscal year 2000 revenues by approximately $1.4 billion.
>
> The complaint further alleges that Nortel had improperly established, and was improperly maintaining, over $400 million in excess reserves by the time it

112 Securities Exchange Commission, *Nortel Networks Pays $35 Million to Settle Financial Fraud Charges*, Press Release 2007-217 *Washington, D.C., Oct. 15, 2007*

> announced its fiscal year 2002 financial results. According to the complaint, these reserve manipulations erased Nortel's fourth quarter 2002 pro forma profit and allowed it to report a loss instead so that Nortel would not show a profit earlier than it had previously forecast to the market. The complaint alleges that in the first and second quarters of 2003, Nortel improperly released approximately $500 million in excess reserves to boost its earnings and fabricate a return to profitability. These efforts turned Nortel's first quarter 2003 loss into a reported profit under GAAP, and largely erased its second quarter loss while generating a *pro forma* profit. According to the complaint, in both quarters Nortel's inflated earnings allowed it to pay tens of millions of dollars in so called "return to profitability" bonuses, largely to a select group of senior managers."[113]

Nortel Networks has subsequently gone in to bankruptcy. The Canadian Broadcasting Corporation summed up the history of Nortel in the wake of its accounting fraud as follows:

> "…Nortel — which was once the cornerstone of Canada's technology industry, with a market valuation of nearly **$300 billion** — will close next month. As Canada's technology giant, Nortel once boasted a market capitalization about half the size of Mexico's entire gross national income and a workforce equal to the population of Waterloo, Ont. But as the telecommunications equipment maker slid into bankruptcy in January, Nortel's net worth was said to be a shade under **$200 million**.[114]

The losses to shareholders total nearly the entire Cdn$300 billion dollar market value. In 2007 the SEC has also instituted civil fraud claims against the former CEO of Nortel, Frank Dunn, and two other Nortel executives. In 2008 the Royal Canadian Mounted Police charged all three

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[113] Ibid.

[114] Canadian Broadcasting Corporation, Canada's Technology Star Becomes Financial Black Hole *September 16, 2009* http://www.cbc.ca/money/story/2009/01/14/f-nortel-backgrounder-january09.html#ixzz0wOfrdc6z

executives with criminal fraud.[115]

III. LEHMAN BROTHERS

Lehman Brothers had a long history of abusing the securities markets through the manipulation of information.[116] The author has recently written extensively on the subject of the Lehman Brothers failure and its misrepresentation of its true financial condition in order to maintain the false perception that it was a sound Investment Bank with a strong balance sheet. The reality, as history has shown, was quite different. Lehman Brothers willfully maneuvered its illiquid assets to a lower regulatory burden and accounting jurisdiction (i.e., England/Europe) in order to camouflage debt as equity. The recent speech to House Committee on Financial Markets by James L Kroeker, Chief Accountant of the Office of the Chief Accountant ("OCA"), principal advisor to the SEC, sets out the scope and sophistication of the accounting fraud perpetrated by Lehman Brothers on the marketplace:

> "The [Bankruptcy] Examiner's Report highlighted Lehman's use of certain transactions in an attempt to affect liquidity measures, particularly through transactions that were so-called "Repo 105" transactions.[2] A repurchase agreement is a contract to sell a security today and to repurchase that same security at a date in the future for a set price.
>
> U.S. GAAP provides guidance on accounting for transfers of assets. Under that guidance, typical repo transactions are treated as secured borrowings. However, in the case of Repo 105 transactions, Lehman treated the transactions as sales for accounting purposes. According to the Examiner's Report, a careful review of Lehman's Forms 10-K and 10-Q would not reveal Lehman's use of Repo 105 transactions, and internal Lehman officials appear to have indicated that the only purpose or motive for the

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[115] Ibid.

[116] Securities and Exchange Commission v. Lehman Brothers Inc., 03 CV 2940 (WHP) (S.D.N.Y.) Litigation Release No. 18116 / April 28, 2003 The SEC sued Lehman Brothers for research analyst conflicts of interest firm to settle with SEC, NASD, NYSE, New York Attorney General, and State Regulators , pleads Nolo Contendre and settles with a US$ 50 million civil penalty.

> transactions was reduction in the balance sheet [debt]. Nevertheless, in treating these transactions as sales, the securities were taken off of the balance sheet until the securities were repurchased. According to the Examiner's Report, the cash received in the transfers was then used to pay down other liabilities. In accounting for these transactions as sales rather than secured borrowings, Lehman apparently concluded that the transferred securities had been legally isolated and that the collateralization did not provide effective control over the transferred securities.
>
> Serious questions were raised in the Examiner's Report as to whether Lehman complied with existing accounting standards and further, whether it was transparent with its investors about the nature and purpose of the transactions. In addition to questions about the proper accounting for these transactions - that is, whether the Repo 105 transactions should have been recorded on Lehman's balance sheet - there are also questions about whether there was proper [accounting] disclosure. Lehman did not disclose that it accounted for its repurchase transactions as sales. To the contrary, it reported [to regulators] that it accounted for its repo transactions as financings, the typical accounting treatment for repurchase transactions. There are serious questions about compliance with existing accounting and disclosure requirements related to the Repo 105 transactions.
>
> If entities are **using transaction structures solely to achieve an artificial result and mask transparency to investors**, this represents a serious threat to investor confidence and the integrity of our financial reporting system." [emphasis added]

The guidance of Lord Diplock is helpful in understanding the above quotation from James Kroeker. Diplock LJ states:

> "It is, I think, necessary to consider what, if any, legal concept is involved in the use of this popular and pejorative word. I apprehend that, if it has any meaning in law, it means acts done or documents executed by the parties to the "sham"

> which are intended by them to give to third parties or to the court the appearance of creating between the parties legal rights and obligations different from the actual legal rights and obligations (if any) which the parties intend to create".[117]

It's true that no one in the Lehman Brothers case has yet to be formally charged, and the bankruptcy proceedings over Lehman Brothers may preoccupy US authorities for years, it is nonetheless apparent from Lehman's failure that it did not have the level of solvency that it represented to the marketplace during the months leading up to its failure in late 2008. In fact, during the months leading up to its demise, Lehman Brothers raised US$ 12 billion in the public markets, a large sum that was in this author's view, effectively stolen from the pockets of the pension funds of average investors.

The author predicts that certain Lehman executives will have civil proceedings brought for accounting fraud, and in all probability the persons responsible for the Repo 105/108 transactions which were loans dressed up as sales (see Enron), and at least two Lehman executives will be charged with criminal fraud in connection with this dubious accounting practice.

Enron, Nortel and Lehman Brothers are three examples of three different types of accounting fraud. All three used a range of sham transactions[118] to achieve the illusion of financial and managerial performance that was not an accurate reflection of the true performance of the companies. As with most companies that perpetrate fraud, all three companies are now defunct. What about Dell Inc?

DELL INC.

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[117] *Snook v London & West Riding Investments* [1967] 2 QB at 801 per Diplock LJ
[118] Ibid.

Dell Inc has a current market capitalization of nearly US$ 27 billion and touts itself as the world's second largest computer maker.[119] According the Fortune Magazine, the Founder of Dell Inc, Mr. Michael Dell, is the 37th wealthiest person in the world with a net worth of US$13.5 billion.

On 4 April 2007 Dell announced to the market that it would not be able to file its 10K on time. The report filed with EDGAR stated:

> "Dell Inc. is delaying the filing of the Form 10-K for its fiscal year ended February 2, 2007 (the "FY2007 Form 10-K") because the independent investigation being conducted by the Audit Committee of the company's Board of Directors has not been completed. As previously announced, the U.S. Securities and Exchange Commission ("SEC") and the Audit Committee are conducting investigations into certain accounting and financial reporting matters, including issues relating to reserves and other balance sheet items that may affect the company's previously reported financial results, and the company previously received a related subpoena from the United States Attorney for the Southern District of New York."
> The Audit Committee's investigation has identified a number of accounting errors, evidence of misconduct, and deficiencies in the financial control environment. The Audit Committee is working with management and the company's independent auditors to determine whether the accounting errors necessitate any restatements of prior period financial statements, and to assess whether the control deficiencies constitute a material weakness in Dell's internal control over financial reporting."[120]

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[119] Dell Inc., *Dell's Financial History* http://content.dell.com/us/en/corp/investor-financial-reporting.aspx at 8 August 2010

[120] EDGAR Online, United States Securities And Exchange Commission, Form 10-Q/A Dell Inc, *Quarterly Report Pursuant To Section 13 Or 15(D) Of The Securities Exchange Act Of 1934* for the quarterly period ended May 5, 2006

Later in 2007, when Dell finally reported on its 2006 financial performance, it included a note which, inter alia, states:

> "*Investigations and Related Litigation* — In August 2005, the U.S. Securities and Exchange Commission ("SEC") initiated an inquiry into certain of our accounting and financial reporting matters and requested that we provide certain documents. The SEC expanded that inquiry in June 2006 and entered a formal order of investigation in October 2006. The SEC's requests for information were joined by a similar request from the United States Attorney for the Southern District of New York ("SDNY"), who subpoenaed documents related to our financial reporting from and after 2002. In August 2006, because of potential issues identified in the course of responding to the SEC's requests…"[121]

From 4 April 2007 when Dell announced it could not file its 2006 results on time, which is frequently an indication of an accounting problem,[122] until 8 October 2007 when Dell announced that it was being investigated by the SEC and would be restating its earnings, the trading price of Dell securities declined by approximately 50%. At an average daily trading volume of 810,000, 149 million Dell shares[123] changed hands during the time that the market had been signaled of accounting problems within Dell. Assuming the average securities purchaser holds the stock for 30 days, the loss per share is US$3.33, or a total loss to securities holders of US$496.7 million.

On 22 July 2010 the United States Securities and Exchange Commission ("SEC") filed a claim against Dell Inc, and its Founder, as well as both current and former officers for, inter alia, accounting fraud and material non-disclosure. The claim filed by the SEC is summarized at paragraph 2 of the SEC Statement of Claim filed in the Delaware District Court as follows:

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[121] Ibid.
[122] Smith, Kevin C. *What Late SEC Filers Need to Know* (2005) Bloomberg LLC
[123] NASDAQ real-time data, at 4 August 2010

> "From 2002 to 2006, Dell failed to disclose the significant benefits it received from large payments from Intel and materially misrepresented the basis for its improving profitability. In Dell's Forms 10-Q and 10-K for this period, and in other public statements, Michael Dell, Rollins, Schneider and others repeatedly cited certain "cost reduction initiatives" and "declining component costs" as the bases for Dell's increasing profit margins. In fact, Dell's increasing profitability was largely attributable to an unusual source of funds: payments from Intel, a microprocessor manufacturer that was one of Dell's largest vendors. During this period, Intel effectively paid Dell not to use processors manufactured by Advanced Micro Devices, Inc. ("AMD"), Intel's arch-rival. Intel's payments to Dell, which were the subject of various antitrust investigations and claims, grew significantly. When measured as a percentage of Dell's operating income, these payments grew from about 10% in fiscal year 2003 ("FY03") to 38% in FY06, peaking at 76% in the first quarter of fiscal 2007 ("Q1FY07"). While almost all of the Intel funds were incorporated into Dell's component costs, Dell did not disclose the existence, much less the magnitude, of the Intel exclusivity payments.[124]

Dell Inc and its officers and directors were charged for violations of Section 17(a) of the Securities Act of 1933, and Sections 10(b), 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Securities Exchange Act of 1934, along with Securities Rules 10b-5, 12b-20, 13a-1, and 13a-13.[125]

The Delaware District Court has not yet accepted the various pleas of Dell Inc, Michael Dell, and the other officers and directors of Dell, but the consents between the SEC and Dell et. al. are as follows:

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[124] *Securities Exchange Commission v Dell, Inc., Michael S. Dell, Kevin B. Rollins, James M. Schneider, Leslie L. Jackson, Nicholas A. R. Dunning*, United States District Court District Of Columbia, Case No: 1:1O-cv-01245

[125] *U.S. Securities and Exchange Commission, Litigation Release* No. 21599 / July 22, 2010
Accounting and Auditing Enforcement Release No. 3156 / July 22, 2010

1. Dell Inc. consented to an Order to reconstitute its Disclosure Review Committee and to amend its disclosure processes, including the retention of outside advisors to recommend improvements to reporting processes and to enhance training regarding the disclosure requirements of the federal securities laws.[126]

2. The Founder, Michael Dell, and the former CEO, Kevin Rollins, each paid a fine of US$4.0 million, and consented to settle the SEC's disclosure charges, without admitting to the SEC's allegations, to the entry of an Order Semper that enjoins them from violating Sections 17(a)(2) and (3) of the Securities Act and from violating or aiding and abetting violations of other provisions of the federal securities laws.[127]

3. The former CEO of Dell Inc, James Schneider, consented to settle the disclosure and accounting fraud charges against him without admitting to the SEC's allegations, and agreed to pay a fine totaling $83,096, plus prejudgment interest of $38,640.[128]

4. Senior accounting staff, Dunning and Jackson consented to settle the SEC's improper accounting charges without admitting to the SEC's allegations, but each agreed to pay a penalty of $50,000. Schneider, Dunning and Jackson consented to the issuance of administrative orders pursuant to Rule 102(e) of the Commission's Rules of Practice, prohibiting each of them from acting as auditors or accountants or public companies in the US for periods ranging from 3 to 5 years.[129]

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[126] *U.S. Securities and Exchange Commission, Litigation Release* No. 21599 / July 22, 2010 Accounting and Auditing Enforcement Release No. 3156 / July 22, 2010
[127] Ibid.
[128] Ibid.
[129] Ibid.

Robert Khuzami, Director of the SEC's Division of Enforcement, speaking about the Dell Inc. charge and settlement announced that:

> "**Accuracy and completeness are the touchstones** of public company disclosure under the federal securities laws. Michael Dell and other senior Dell executives fell short of that standard repeatedly over many years, and today they are held accountable." [emphasis added]

The market has assumed that Michael Dell as Chairman and CEO is so important to Dell Inc that the SEC decided removing him from the company would cause current shareholders more harm than penalizing him for his misdeeds in accordance with precedent. This is evidenced by the fact that the announcement has resulted in Edward Jones, a large American Dealer-Broker, issuing a buy rating on the stock.[130] As at April 2010 Michael Dell was judged by Fortune Magazine to be the 37th wealthiest man in the world with a net worth of US$13.5 billion.[131] The day before the SEC announced that it was charging Dell with accounting fraud, Dell's shares closed at $13.07. The day the settlement was announced, Dell shares closed at $13.40, a gain of 2.5%. The following day, Dell shares closed even higher, at $13.51.[132]

To summarize, Dell Inc recorded illegal anti-trust payments from Intel as operating revenues in each of 2002 through 2006 fiscal years. In 2006 payments from Intel accounting for more than three quarters of Dell's operating revenue. This compares with 20% of revenue for Enron, less than 10% for Nortel, and only 7% of the asset base for Lehman Brothers.

INTEL

The counter-party to the Dell accounting fraud, was Intel, who made illegal payments to tier one computer makers in order to shut out competition from other chip makers. On 13 May 2009,

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[130] Edward Jones LLC, *Edward Jones Analyst Report*, 23 July 2010 http://finance.yahoo.com/q/bc?s=DELL at 4 August 2010

[131] *The World's Rich List* Fortune Magazine April 2010 p.46

[132] Krantz, Matthew *Why Investors Yawn When Companies Settle Fraud Charges*, USA Today 2 August 2010

the European Commission adopted a decision, which concludes that Intel Corporation infringed Article 82 of the EC Treaty by abusing its dominant position on the x86 central processing unit (CPU) market. The decision imposed a fine of EUR 1.06 billion and obliged Intel to cease the identified illegal practices, to the extent that they are ongoing, and not to engage in the same or equivalent practices in the future. The announcement from the EC states:

> "Intel has harmed millions of European consumers by deliberately acting to keep competitors out of the market for computer chips for many years. Such a serious and sustained violation of the EU's antitrust rules cannot be tolerated.[133]

Dell received payments from Intel with knowledge that these payments violated both the Sherman Act, the Clayton Act, and the Robinson-Patman anti-trust laws of the United States. [134] The payments from Intel, as set out by the European Commission on Competition can only be characterized as illegal. Simply put, Dell was the beneficiary of payments from Intel to exclude all other chip manufacturers from its computers. The Federal Trade Commission charged Intel for making these payments in December 2009:

> "The FTC sued Intel in December 2009 alleging that the company used anticompetitive tactics to cut off rivals' access to the marketplace and deprive consumers of choice and innovation in the microchips that comprise computers' central processing unit, or CPU. These chips are critical components that often are referred to as the "brains" of a computer. The action also challenged Intel's conduct in markets for graphics processing units and other chips.
>
> The FTC alleged that Intel's anticompetitive practices violated Section 5 of the FTC Act, which is broader than the antitrust laws and prohibits unfair methods of

[133] Kroes, Neelie, European Commissioner for Competition http://ec.europa.eu/competition/sectors/ICT/intel.html at 03 August 2010

[134] *Securities Exchange Commission v Dell, Inc., Michael S. Dell, Kevin B. Rollins, James M. Schneider, Leslie L. Jackson, Nicholas A. R. Dunning*, United States District Court District Of Columbia, Case No: 1:1O-cv-01245 p. 17 (Note that this is taken from an email exchange between the then Controller of Dell and the then CEO, just prior to announcing financial results to the market.)

> competition and deceptive acts and practices in commerce. Unlike an antitrust violation, a violation of Section 5 cannot be used to establish liability for plaintiffs to seek triple damages in private litigation against the same defendant."[135]

The Federal Trade Commission in an August 2010 Press Release indicate they have settled the case against Intel who, inter alia, will be prohibited from:

> "…conditioning benefits [payments] to computer makers in exchange for their promise to buy chips from Intel exclusively or to refuse to buy chips from others;" [136]

DELL SETTLEMENT WITH SEC

Dell Inc. consented to the entry of an order in the Delaware District Court that enjoins it from violating Section 17(a) of the Securities Act of 1933 and Sections 10(b), 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Securities Exchange Act of 1934 and Rules 10b-5, 12b-20, 13a-1, and 13a-13.[137] Dell Inc. also agreed to enhance its Disclosure Review Committee and disclosure processes, including the retention of an independent consultant to recommend improvements to those processes and enhance training regarding the disclosure requirements of the federal securities laws.[138] Dell has agreed to plead nolo contendre and agreed to pay fines totaling USD100million. Michael Dell, along with other officers (past and present), and certain accounting staff, will pay approximately US$ 8.0 million in penalties.[139]

It should be noted that what is colloquially known as Financial Statement Fraud is set out at s 1350 where it states:

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[135] *Intel Corporation v The Federal Trade Commission* [2009] Docket No. 9341, File No: 061 0247

[136] Ibid.

[137] *U.S. Securities and Exchange Commission, Litigation Release* No. 21599 / July 22, 2010 Accounting and Auditing Enforcement Release No. 3156 / July 22, 2010

[138] Ibid.

[139] Ibid.

Failure of corporate officers to certify financial reports

> *(a)* ***Certification of Periodic Financial Reports.*** *Each periodic report containing financial statements filed by an issuer with the Securities Exchange Commission pursuant to section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m (a) or 78o (d)) shall be accompanied by a written statement by the chief executive officer and chief financial officer (or equivalent thereof) of the issuer.*
>
> *(b)* ***Content.*** *The statement required under subsection (a) shall certify that the periodic report containing the financial statements fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act 1934 (15 U.S.C. 78m or 78o (d)) and that information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of the issuer.*[140]

TIME FOR SUBSTANTIVE CHANGE

Sir Ken Macdonald QC, the head of the United Kingdom's Department of Public Prosecution from 2003 to 2008 was quoted in the Times as saying:

> "Our system for regulating markets and for prosecuting market crime is completely broken".[141]

The author takes the view that Sir Ken Macdonald is right. The system of policing and deterring securities market abuses seems to have done nothing to stem the tide of

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[140] Ibid.
[141] Macdonald, Ken QC The Times, 23 February 2009 p. 1

accounting frauds leading up to the Global Financial Crisis.[142] The author will respectfully suggest certain changes, and subjects for further discussion, which may provide a more effective deterrent to accounting fraud in global securities markets, using the SEC settlement with Dell Inc to illustrate the point.

TAX DEDUCTIBILITY OF MONIES PAID TO SEC

In its quarterly guidance filed with EDGAR, Dell Inc has mooted the view that the monies paid to the SEC (supra.) are largely deductible from income tax and will therefore not have a material impact of the company's financial performance. Dell may deduct the recent US$ 100 million payments made to the SEC from its annual income tax[143]. It is worth noting that the settlement between the Securities Exchange Commission and ten Wall Street Investment Banks in 2003, expressly barred the banks from deducting the penalties paid to the SEC from their income tax.[144]

This is clearly wrong. There is a public policy presumption that only monies paid in restitution should be tax deductible. Monies paid as penalties or part of a criminal sentence are not intended to be deductible under US law. Unfortunately, the law on this matter is far from clear, and is made less clear by a key decision in *Commissioner v Tellier* (1966) USC[145] which contradicts the public policy presumption, that is codified in the US Tax Code at s162(f) and at s165. There was a new law mooted by US Congress in 2003 but the Bush era was a time when

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142 Thomas L.J. *The Financial Crisis: The Role Of Law And Regulation* The Lord Merlyn-Rees Lecture University of Glamorgan 5 March 2009

143 Dell Inc. 10Q www.sec.gov/EDGAR/dell/filings/2010/q1/guidance

144 Securities Exchange Commission, North American Stock Administrators Association, New York Attorney General, New York Stock Exchange, National Association of Stock Dealers, Joint Press Release 2003-54, Bear, Stearns & Co. Inc. (Bear Sterns) Credit Suisse First Boston LLC (CSFB) Goldman, Sachs & Co. (Goldman) Lehman Brothers Inc. (Lehman) J.P. Morgan Securities Inc. (J.P. Morgan) Merrill Lynch, Pierce, Fenner & Smith, Incorporated (Merrill Lynch), Morgan Stanley & Co. Incorporated (Morgan Stanley), Citigroup Global Markets Inc. f/k/a Salomon Smith Barney Inc. (SSB), UBS Warburg LLC (UBS), U.S. Bancorp Piper Jaffray Inc. (Piper Jaffray) agree to pay US$ 1.4 billion fine to settle claims that Investment Banks used their own Analysts Reports to promote the stocks of banking clients to retail clients; and earning fees from both sides of the transaction. http://www.sec.gov/news/press/2003-54.htm at 1 March 2010

145 *Commissioner v. Tellier* (1966)383 U.S. 687 p. 3

less was more, and the bill never made it through first reading. In this Author's opinion, the time to resurrect this bill is long overdue. It is an affront to public policy that a tax deduction should be allowed in any circumstance where a legal person settles an SEC fraud claim; be it civil, criminal or restitutionary in nature.

In 2003, ten Wall Street Investment Banks agreed to pay aggregate penalties totaling US$1.4 billion to the SEC[146] for releasing false information about corporate securities in the reports of Analysts who were employed in the research departments of these same banks. The potential for legislative change was made by accountant and author, Allen M. Beck CPA:

> "The $1.4 billion settlement comprised $487.5 million in penalties, $387.5 million in disgorgement, $432.5 million to fund independent research and $80 million to fund and promote investor education. The Global Settlement, as well as recent agreements reached by MCI [Worldcom] and others have brought attention to uncertainties as to the tax treatment of settlement payments. The possibility of the firms obtaining sizable tax benefits from deducting the payments raised a political outcry and prompted proposed legislation to expand the definition of nondeductible fines or penalties.[147]

The cases decided on the issue of the deductibility of monies paid to settle an SEC securities fraud action have been varied, notwithstanding what seems to have been a clear intention of

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[146] Securities Exchange Commission, North American Stock Administrators Association, New York Attorney General, New York Stock Exchange, National Association of Stock Dealers, Joint Press Release 2003-54, Bear, Stearns & Co. Inc. (Bear Sterns) Credit Suisse First Boston LLC (CSFB) Goldman, Sachs & Co. (Goldman) Lehman Brothers Inc. (Lehman) J.P. Morgan Securities Inc. (J.P. Morgan) Merrill Lynch, Pierce, Fenner & Smith, Incorporated (Merrill Lynch), Morgan Stanley & Co. Incorporated (Morgan Stanley), Citigroup Global Markets Inc. f/k/a Salomon Smith Barney Inc. (SSB), UBS Warburg LLC (UBS), U.S. Bancorp Piper Jaffray Inc. (Piper Jaffray) agree to pay US$ 1.4 billion fine to settle claims that Investment Banks used their own Analysts Reports to promote the stocks of banking clients to retail clients; and earning fees from both sides of the transaction. http://www.sec.gov/news/press/2003-54.htm at 1 March 2010

[147] Beck, Allen M, *The Global Settlement and Tax Deductibility of Fines And Penalties,* Tax Advisor 1 October 2003

Congress in s162(f) and s165 of the US Tax Code.[148] The Bill that would have given the Internal Revenue Service, and the courts clear direction on this issue, never made it out of the Bush (pardon the Outback pun) in 2003. The Author believes there can be no doubt in 2010 that the Bill should be drawn from the Congressional ashes of the Bush-era, and should make it clear that taxpayers will not under any circumstances assist in settling securities fraud claims by the SEC. There should be an unambiguous legislative response to the Supreme Court's interpretation of the public policy prohibition against tax deductibility, making it clear in every conceivable circumstance that neither civil or criminal penalties shall be deductible, and the same should be true for any restitutionary payments. This enactment would provide a further disincentive to officers and directors of companies who are intent on committing accounting fraud.

NO ATTRIBUTION WHERE OFFICER OR DIRECTOR DAMAGE THE COMPANY

The word 'vicarious' derives from the Latin word meaning 'change' or 'alternation'. In tort law the word refers to the concept of one person being liable for the damage caused by another, in a circumstance where the parties to the tort have a legal relationship which is germane. An example might be a parent and child; or an employer and employee.

You can sue an employer for the damage to you by their employee, which was caused within the scope of her employment. For example, if an employee spilled liquid on the retail store floor, and a customer slipped, fell, and suffered an injury, the injured person could sue the employee and her employer. This is sometimes referred to as respondiat superior. The law states that when your employee harms the claimant in the course of her employment, the employer bears responsibility because the employer has control to hire and fire him, and reduce the risk of it happening again. There is considerable academic debate about whether vicarious

[148] Wood, Robert W *Cleaning Up: Tax Deductions for Restitution, Fines, and Penalties* Tax Notes: Tax Practice, The Tax Institute 26 January 2009

liability is justified on no better foundation than the search for the defendant with the deepest pockets.[149]

However, Professor John Farrar notes the following important distinction where attribution or vicarious liability serves the interest of justice. He states:

> "An employee who acts for the company in the course of his or her employment will usually bind the company and his or her knowledge will be attributed to the company because he or she is the company for the purpose of the transaction in question.
>
> This is so even if the employee is acting dishonestly or against the interests of the company or contrary to orders but it is not so where the company is the victim. This is to avoid an obvious contradiction."[150]

The author's assertion is that in a circumstance where the company is also injured by the tort or the crime of the officers or directors, it would be an invidious outcome for the company to pay compensation for the wrongdoing of the tortfeasor or the criminal. In a circumstance where the damage done to the company is material, and there was a clear intention on the part of the director or officer to deceive or to employ some artifice or device, then the company should not be required to pay the damages. This outcome should also be legislated.

PENALTIES MUST EQUAL OR EXCEED COMMON LAW REMEDIES

It should not be necessary for a securities purchaser to prove that he relied upon the express representations of the officer or directors of a publicly traded company. It should be sufficient that he followed the market in the belief that market had accurate information. The legal measure of damages in an action in deceit when applied to securities transactions may be

[149] Jones, Michael A, Textbook on Torts, 2000 Thomson West Publishing p379
[150] Farrar, John *Farrar's Company Law*, 4th Ed. at 147

difficult to calculate, because it is not just an issue of the market's perceived value of the stock, but rather a function of the opportunity cost of the investor. If loss is to be determined by way of the price paid less a valuation of the shares at a given date, the determination of the real or true value of the shares, absent the deceit forming the basis of the claim, may give rise to difficult hypothetical problems; however this does not mean that investors who have been misled by widespread false statements about the value of the stock of the company should not be entitled to recover the damages available in a tort of deceit action on the case.

None of the practical questions in calculating damages warrant application of a special rule in respect of losses incurred as a result of accounting fraud induced share transactions. The same legal principle must govern the sales of shares, goods, a business, land, or any other property. If this principle based approach to recovery of investor damages was applied, the problem would be simpler for all parties. The example given by Cockburn C.J. is instructive. He said:

> "If a man buys a horse, as a racehorse, on the false representation that it has won some great race, while in reality it is a horse of very inferior speed, and he pays ten or twenty times as much as the horse is worth, and after the buyer has got the animal home it dies of some latent disease inherent in its system at the time he bought it, he may claim the entire price he gave; the horse was by reason of the latent mischief worthless when he bought; but if it catches some disease and dies, the buyer cannot claim the entire value of the horse, which he is no longer in a condition to restore, but only the difference between the price he gave and the real value at the time he bought."[151]

The House of Lords unanimously affirm the decision of Chadwick J. in his decision in a case involving City of London securities fraud; namely they affirm the restitutionary principles in the common law tort of deceit as applied to securities:

[151] *Twycross v. Grant* (1877) 2 C.P.D. 469 pp. 544-545

> "For more than a hundred years at least English law has adopted a policy of imposing more extensive liability on intentional wrongdoers than on merely careless defendants. This policy was trenchantly spelt out by Lord Blackburn in *Livingstone v. Rawyards Coal Co.* (1880) 5 App.Cas. 25."[152]

Their Lordships conclude that there has been no change in the principle that underlies the obligations that the law imposes on a tortfeasor in deceit. It was said:

> "Since Victorian times there have been great developments in our law of obligations. But there has been no retreat from the policy spelt out by Lord Blackburn. On the other hand, the way in which the law can distinguish between the intentional wrongdoer and a man who caused loss by a foolish but honest mistake was not worked out clearly in the old cases.
>
> *Pasley v. Freeman*, decided more than 200 years ago, marks the emergence of the tort of deceit: (1789) 3 Durn. & E. 51. In cases framed in deceit the measure of damages was held to involve **ascertainment of the "real" or "face" value of the shares at the time of allotment or purchase**. See *Davidson v. Tullock* (1860) 36 L.T. 97; *Peek v. Derry* (1887) 37 Ch.D. 541; reversed on liability (1889) 14 App.Cas. 337; *Arkwright v. Newbold* (1881) 17 Ch.D. 301, reversed on liability, 17 Ch.D. 313; *Broome v. Speak* [1903] 1 Ch. 586, (affirmed *Shepheard v. Broome* [1904] A.C. 342).[153] [emphasis added]

One must therefore conclude that this is the correct way to determine the damages suffered by the purchasers of Dell securities from 2002 through 2006. Clearly if a hypothetical stockholder purchased at the peak in 2002 and did not sell her Dell stock until late 2007 when she needed the money to pay college tuition, she has half the money coming out of the transaction that she had going in. She suffered real loss, and this loss, along with the losses of all the other

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[152] *Smith New Court Securities v. Scrimgeour Vickers* [1992] B.C.L.C. 1104 at 16

[153] Ibid. at 25

purchasers of Dell securities should be repaid by Michael Dell, personally. In the respectful view of the Author, the SEC should be directed to pursue this end as a policy in every case where the perpetrator/s of the fraud have the means, especially by disposal of their stock in the company, to make whole those who relied on their misleading statements and suffered a loss.

The decision of Dixon J in the High Court of Australia states the same thing in one of the first recorded cases of securities fraud in Australia;

> "The measure of damage in a case in which a person is induced by fraud to the. take up shares in a company is the difference between the amount he paid for the shares and the real value of the shares at the time of allotment, and not at any subsequent period, although subsequent events may throw light on the value at the time of allotment…"

The SEC should be directed by Congress that where there is value to be harvested from the personal holdings of the tortfeasor, the SEC's obligation is to recover the losses of the purchasers of the securities, as near as possible.

GAINS FROM SHAM ACCOUNTING SHALL BE DISGORGED

It seems to have been overlooked that fraud is a coin minted with two sides. The first side, as set out in great detail above, is the loss suffered by the victim of the tortfeasor. The second, and less storied side of the fraud coin is the gain made by the tortfeasor. As a principle, any gains made in a sham transaction should be disgorged.[154] In the case of Dell, at the height of the accounting fraud, the largest shareholder, Michael Dell rose to be the 9th richest man in America.[155] While it's true that his ranking has dropped substantially, it could well afford to drop.

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[154] *Snook v London & West Riding Investments* [1967] 2 QB

[155] Miller, Matthew Serafin, Tatiana**,** *The 400 Richest Americans, Fortune Magazine* 21 September 2006

The value of each share of the perpetrator of the tort of deceit or fraudulent misrepresentation should be determined at the lowest value that the market would have ascribed, using comparables from the period during which the accounting fraud occurred, and this is the amount of value that should be taken from the stockholders, who have gained from their fraudulent acts.

In the case of Dell, it would be relatively straight forward to calculate based on the average P/E multiple assigned to Dell's operating revenue during the period from 2002 to 2006 what the stock would have been worth, had Michael Dell and other officers of the company not taken the decision to include illegal payments from Intel as part of the income stream of the company. The difference between the real value and the fraudulently inflated value should be taken from the perpetrators. To the extent that this amount is greater than the sums needed to restore the losses described above, this amount should be kept by the SEC as a penalty, with a chilling deterrent affect on others who might wish to perpetrate an accounting fraud.

CONSISTENCY IN PENATIES, RESTITUION AND SENTENCING

The Smith principle, namely consistency in sentencing,[156] is a hallmark of criminal sentencing in the common law; and certainly as the law is applied in Australia. Peter Henning, a Professor at Wayne State University Law School, commenting on the SEC – Dell Inc settlement noted:

> "In similar cases, where there was clear evidence that the Founder knew of the accounting misrepresentation, you'd expect the SEC to seek a bar against [that] senior officer."[157]

The examples of Enron, Nortel, illustrate that the SEC is not consistent in its application of securities laws in the United States. In both cases, the officers who perpetrated the accounting

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156 *Dinsdale v The Queen* [2000] 202 CLR 321

157 Gallu, Joshua and Ricadela, Aaron *Dell Pays $100 Million in SEC Settlement That Lets Founder Stay* Blooomberg 23 July *2010*

fraud have been pursued for larger sums personally, and have been either charged or convicted of criminal fraud.

It has been shown in the history of deceit and fraudulent misrepresentation, coupled with the codification of fraud in the United States, that criminal and civil fraud spring from the same well. Insofar as the criminalization of fraud is the codification of a set of rules that are applied in modern courts in situations where the facts dictate, it seems tempestuous that civil and criminal fraud should apply different standards of consistency. In a criminal context, the common law applies the "Smith Principle" which essentially dictates that despite the sentencing discretion of a judge[158] the courts can only maintain the confidence of the public if there is consistency between criminal matters.

The author takes the strong view that because of the history of deceit, fraud, fraudulent representation, false representations, and shams, the same principle of consistency should be applied by the SEC for both civil and criminal prosecutions. In other words, as has been set out above, one cannot have one type of outcome for a successful accounting fraud, as in the case of Dell, but another standard for an unsuccessful accounting fraud, as in the cases of Kenneth Lay and Jeff Skilling of Enron; or Bernie Ebbers, Founder and CEO of Worldcom,

Such an outcome undermines public confidence in the legislative resolve to stop information tyranny, and to send a clear message to erstwhile accounting fraud tortfeasors and criminals that the outcome is grave and predictable. This observation must be amplified in the wake of the *Dodd-Frank Wall Street Reform and Consumer Protection Act 2010.*

Scholars and lawyers have identified conflicting aims for the law of tort, to some extent reflected in the different types of damages awarded by the courts: compensatory, aggravated and punitive. Glanville Williams saw four possible bases on which torts of deceit and fraudulent misrepresentation rested: appeasement, justice, deterrence and compensation.[159] In the case of

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158 *House v The King* [1936[HCA per Dixon at 53

159 Williams, Glanville, *The Aims of the Law of Tort* (1951) Oxford University Press

accounting fraud in public market companies, the issues should be limited to compensation and deterrence. The author has shown that a common law remedy would provide greater deterrence, particularly if combined with a consistent application of criminal penalties.

PRACTICAL SOLUTION TO LOWER INCIDENCE OF ACCOUNTING FRAUD

Recently, public companies and foreign private issuers that prepare their financial statements in accordance with U.S. generally accepted accounting principles (GAAP), and foreign private issuers that prepare their financial statements using International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB) are required to provide their financial statements to the SEC and on their corporate Web sites in interactive data format using eXtensible Business Reporting Language (XBRL or interactive data).[160] The author is reminded of the old computer aphorism: "garbage in – garbage out".[161]

Apart from the regulatory response that is set out above, the author is of the view that the SEC should charge an annual fee, which is used to engage arms-length Auditors to undertake random audits of the working papers antecedent to the financial reports of public companies. These would be similar to the "stress tests" conducted on banks the world over in the wake of the Global Financial Crisis.

Every company, and each subsidiary in that company, has a Controller who prepares 'working papers' for submission to the company's Auditors, inclusive of all communications in respect of the notes to the financial statements. These working papers should be scanned and deposited electronically, but confidentially, at the end of each financial quarter, and at the end of the year. This involves no additional work for the company insofar as these working papers must be prepared by each subsidiary or division within a public company. The company would not know if and when its working papers may come under scrutiny.

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160 SEC's Final Rules, XBR Rules Alert #2008-26, CAQ 14 May 2008
161 Unattributed source

Congress should consider an amplification of the audit provisions of the *Sarbanes-Oxley Act 2002* whereby reporting irregularities discovered in working papers result in automatic suspension of the credentials of the accountant who prepared the fraudulent working papers. Moreover, the Controller who prepared the working papers, and the Auditor who reviewed the fraudulent working papers, should both be subject to criminal prosecution. In this circumstance there could be no doubt that there was both mens rea and actus reus. Rigorously enforced cases of working paper fraud would provide a significant deterrent to low level staff who feel cajoled or bullied into misstating the financial position of public company, or any one of its subsidiaries.

SUMMARY

It is acknowledged that each of the issues set out in this paper are dealt with in a cursory manner: The issues raised include, statutory remedies for accounting fraud falling short of common law remedies; attribution of liability to the company for the misdeeds of its officers and directors where the company has also been a victim; tax deductibility of civil, criminal and restitutionary penalties; and, consistency in application of securities penalties and remedies. The paper is written with the sincere hope that the suggested issues and possible responses to various legal and regulatory shortcomings and inconsistencies that arise in the disposition of the Dell Inc. case spark further debate and meaningful change.