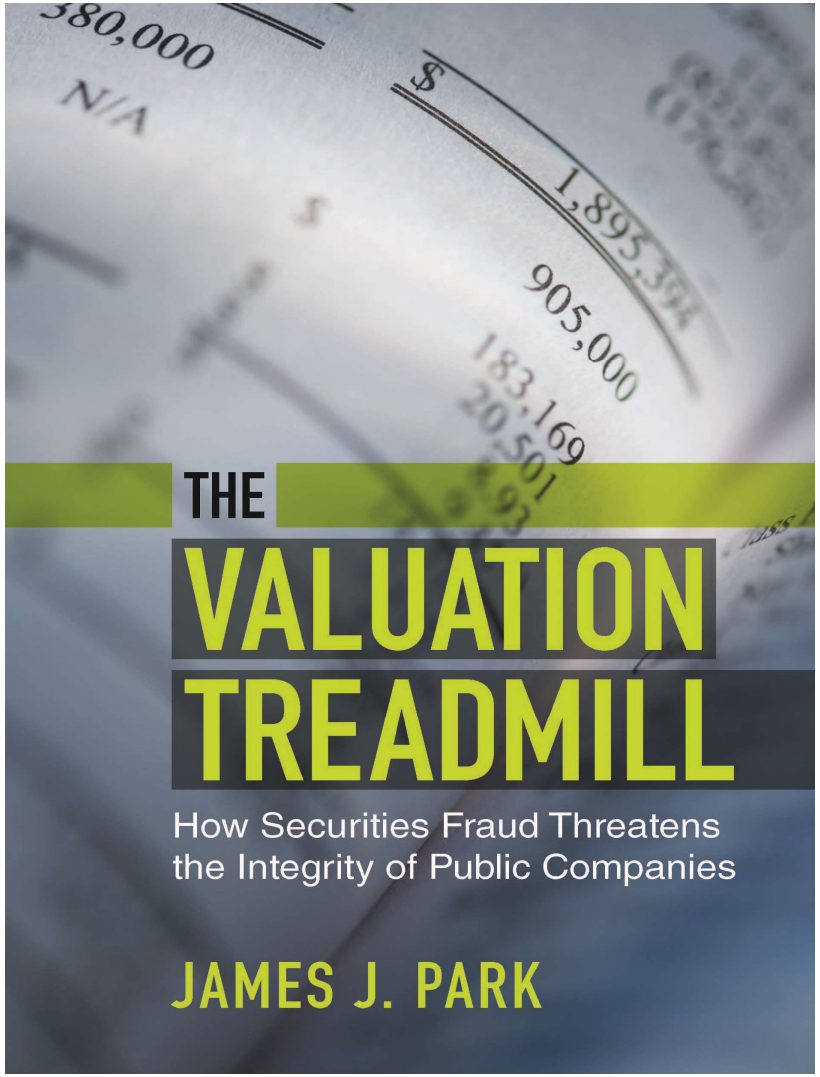
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THE
VALUATION
TREADMILL
How Securities Fraud Threatens
the Integrity of Public Companies
JAMES J. PARK

Elements of a Rule 10b-5 Securities Fraud Claim

- **Misrepresentation** by the Corporation
  - that is **Material** to Investors
  - made with **Fraudulent Intent**
- Causes
- Losses

XEROX
CORPORATION

ENRON

PENN CENTRAL

citigroup

GE

Why do companies commit fraud?

- Create the impression of strong growth
- Hide evidence of a decline in the company's business

Pressure to Increase Earnings

FILED

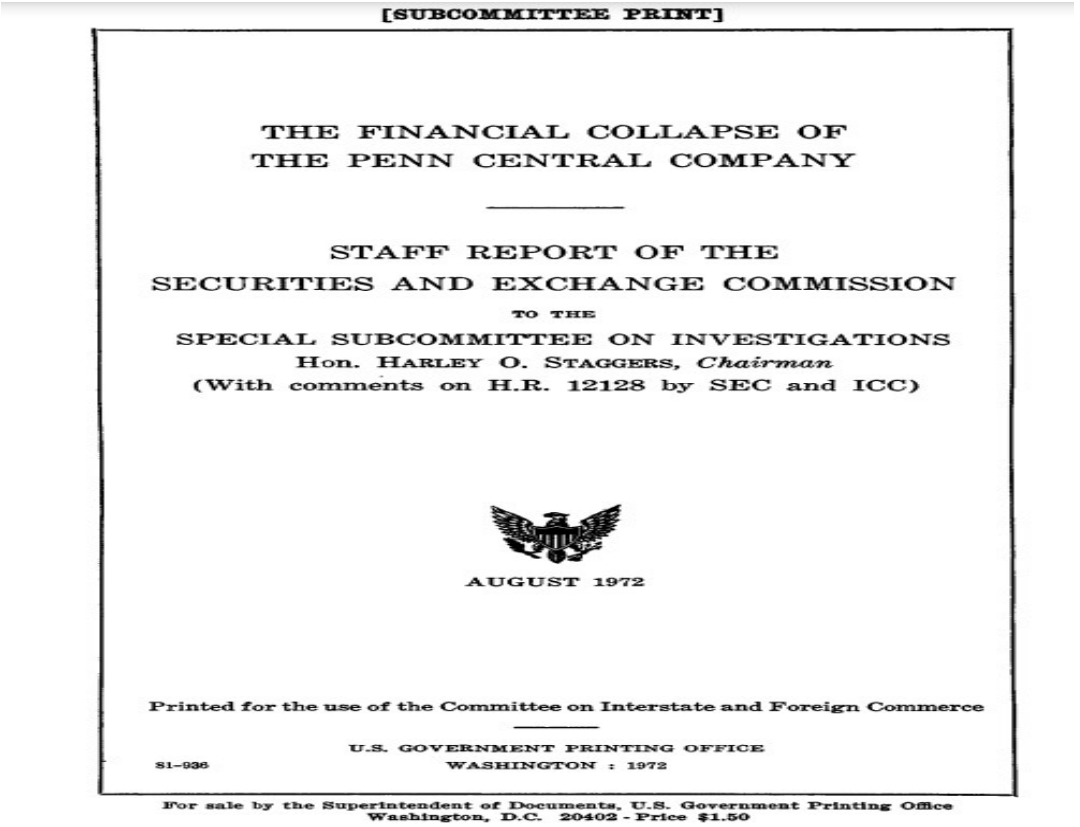
REPORT OF THE TRUSTEE
of
Equity Funding Corporation of America

Pursuant to Section 167 (3)
of The Bankruptcy Act
[11 U.S.C. §567(3)]

First, the fraud at EFCA was essentially a *securities* fraud. While much attention has been focused on the insurance aspects — especially the manufacture of bogus policies — that activity was merely one part of a much larger stock fraud that began at or before the time of EFCA's first public offering in 1964. This scheme appears to have been initially motivated and then sustained throughout the decade of its existence by an obsessive desire on the part of its participants to inflate and keep aloft the market price of EFCA's common stock. It is not incidental that the originators of the conspiracy were also the major holders of the Company's stock, for one result of the fraud was their personal enrichment. It may well be, however, that as time went on pride and vanity played as great a motivating role as greed for many of the participants.

Company. They argued that the only way to eliminate the phony insurance and bogus assets was to stop the artificial increases in corporate growth by reporting "flat earnings" for a while. Earnings would have to be reported at the same level as for the prior year and no additional phony assets could be booked, while at the same time real sales would have to be dramatically increased but not reported. This action was to be coupled with the institution of a new cost control system and drastic cost reductions, hopefully to create real profits. However, Goldblum flatly rejected such proposals. A leveling of reported earnings would adversely affect the market price of EFCA's common stock, a prospect he would not entertain.

Pressure to Hide Decline



[SUBCOMMITTEE PRINT]

THE FINANCIAL COLLAPSE OF
THE PENN CENTRAL COMPANY

STAFF REPORT OF THE
SECURITIES AND EXCHANGE COMMISSION
TO THE
SPECIAL SUBCOMMITTEE ON INVESTIGATIONS
Hon. HARLEY O. STAGGERS, *Chairman*
(With comments on H.R. 12128 by SEC and ICC)

AUGUST 1972

Printed for the use of the Committee on Interstate and Foreign Commerce

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U.S. GOVERNMENT PRINTING OFFICE
WASHINGTON : 1972

51-936

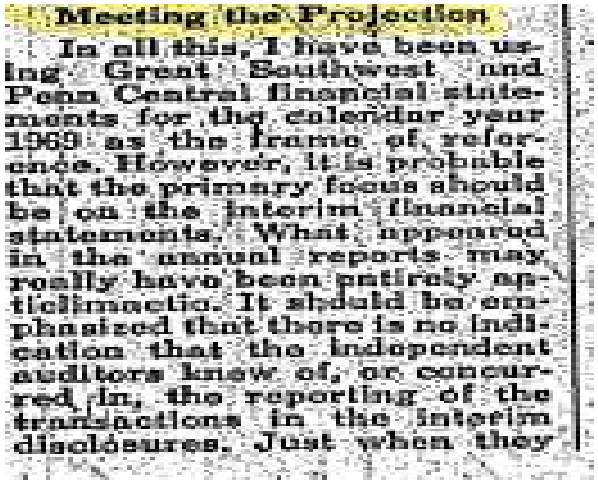
For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, D.C. 20402 - Price $1.50

Six Flags Transaction

- Penn Central sold Six Flags amusement park to a partnership for $29 million
- Penn Central agreed to retain the risk of losses on the amusement park
- Similar problem as the sale of assets to Special Purpose Vehicles by Enron

Why was the transaction material?

- Without the transaction, Penn Central would have reported a loss in a quarter when it had predicted a “favorable showing”



Meeting the Projection

In all this, I have been using Great Southwest and Penn Central financial statements for the calendar year 1969 as the frame of reference. However, it is probable that the primary focus should be on the interim financial statements. What appeared in the annual reports may really have been entirely anticlimactic. It should be emphasized that there is no indication that the independent auditors knew of, or concurred in, the reporting of the transactions in the interim disclosures. Just when they

Pressure to Show Progress on a Product

In re APPLE COMPUTER SECURITIES LITIGATION.

William H. SCHNEIDER; Charles Cohn; Jeanne Cohn; Albert J. Whelen, Jr.; and Estelle B. Ellis; Individuals, On Behalf of Themselves and All Others Similarly Situated, Plaintiffs–Appellants,

v.

John VENNARD; Delbert W. Yocam; Michael Muller; Wilfrid J. Houde; John D. Couch; Gene P. Carter; Kenneth R. Zerbe; Steven P. Jobs; A.C. Markkula, Jr.; John Sculley; Individuals; and Apple Computer Incorporated, a California corporation, Defendants–Appellees.

No. 88–1617.

United States Court of Appeals, Ninth Circuit.

Argued and Submitted Jan. 13, 1989.

Decided Sept. 25, 1989.

Class of stock purchasers brought securities fraud action against computer manufacturer and individual defendants. The United States District Court for the Northern District of California, Robert P. Aguilar, J., 672 F.Supp. 1552, 690 F.Supp. 872, and 696 F.Supp. 490, granted manufacturer's motions for summary judgment. On appeal, the Court of Appeals, Farris, Circuit Judge, held that genuine issues of material fact precluded summary judgment on claims that optimistic statements about compatible disk-drive being introduced with new computer were materially misleading, but there were no triable issues with regard to remainder of claims.

Affirmed in part, reversed in part, and remanded.

1. Federal Courts ⇐759, 776

Grant of summary judgment is reviewed de novo, and Court of Appeals may affirm on any ground that is supported by the record. Fed.Rules Civ.Proc.Rule 56(c), 28 U.S.C.A.

2. Securities Regulation ⇐2511

While materiality and scienter are generally both fact-specific issues which should ordinarily be left to trier of fact, summary judgment may be granted in appropriate securities fraud cases. Securities Exchange Act of 1934, § 1 et seq., 15 U.S.C.A. § 78a et seq.

3. Securities Regulation ⇐60.27(5)

Projections and general expressions of optimism may be actionable under federal securities laws, to extent that one of three implied factual assertions—that statement is generally believed, that there is reasonable basis for that belief, and that speaker is not aware of any undisclosed facts tending to seriously undermine accuracy of statement—is inaccurate.

4. Securities Regulation ⇐60.62

Under "fraud on the market" theory, plaintiff has benefit of presumption that he indirectly relied on alleged misstatement by relying on integrity of stock price established by the market. Securities Exchange Act of 1934, § 10(b), 15 U.S.C.A. § 78j(b).

See publication Words and Phrases for other judicial constructions and definitions.

5. Securities Regulation ⇐60.48(3)

In fraud on the market case, defendant's failure to disclose material information may be excused where that information has been made credibly available to market by other sources. Securities Exchange Act of 1934, § 10(b), 15 U.S.C.A. § 78j(b).

6. Federal Civil Procedure ⇐2511

Genuine issues of material fact, as to whether new disk-drive's technical problems were material facts tending to undermine unqualified optimism of computer manufacturer's statements that drive "ensures greater integrity of data than the other high density drives by way of a unique, double-side mechanism" and that drive "represents three years of research and development and has undergone extensive testing and design verification during the past year," precluded summary judgment on securities fraud claim by class of

sues of material fact. In a November 29, 1982 press release, Apple stated that Twiggy "ensures greater integrity of data than the other high density drives by way of a unique, double-sided mechanism designed and manufactured by Apple." (Statement 4). Apple also claimed that Twiggy "represents three years of research and development and has undergone extensive testing and design verification during the past year." (Statement 5). At the time these optimistic statements were made, internal tests conducted by Apple indicated slowness and unreliability in Twiggy's information-processing capabilities. Approximate-

Did Apple Know the Twiggy was a Failure?

- Two weeks before the press release, a memo warned: “[a]s of now, the Twiggy reliability would LEAD US TO DELAY THE INTRODUCTION OF LISA BY MANY MONTHS.”
- A week after the press release, Steve Jobs said he had “virtually no confidence” in the division responsible for the Twiggy

BUSINESS

Nikola Founder Trevor Milton Convicted of Securities Fraud

Federal jury finds executive guilty of three criminal counts he faced

Nikola founder Trevor Milton, shown outside a New York courthouse last month, resigned in 2020 after a short seller alleged he made misrepresentations about the company.

PHOTO: VICTOR J. BLUE/BLOOMBERG NEWS

We help you strengthen client relationships by all working towards the same goals.

Discover Ownership

Vanguard

The Value of Ownership

• Important information

By Corinne Ramey and Ben Foldy

Updated Oct. 14, 2022 6:21 pm ET

Trevor Milton's Misstatements

- Claimed Nikola had a "fully functioning" semi-truck prototype
- Claimed Nikola had built a electric- and hydrogen- powered pickup from the "ground up"
- Claimed that Nikola was producing hydrogen at reduced cost
- Claimed that Nikola had developed batteries in-house
- Claimed Nikola had billions of dollars in firm orders for its trucks

Nikola admits prototype was rolling downhill in promotional video

"This thing fully functions," Trevor Milton said in 2016. It didn't.

TIMOTHY B. LEE - 9/14/2020, 10:58 AM

Enlarge / A 2018 Nikola video showed the Nikola One prototype rolling down a shallow hill in Utah. Nikola now says it never claimed the truck was driving under its own power.

Pressure to Meet Quarterly Projections

UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

SECURITIES AND EXCHANGE COMMISSION, Plaintiff, v. XEROX CORPORATION, Defendant.	)	Civil Action No. 02-272789 (DLC) COMPLAINT

The Securities and Exchange Commission ("the Commission") alleges for its Complaint as follows:

1. From at least 1997 through 2000, Xerox Corporation ("Xerox") defrauded investors. In a scheme directed and approved by its senior management, Xerox disguised its true operating performance by using undisclosed accounting maneuvers -- most of which were improper -- that accelerated the recognition of equipment revenue by over $3 billion and increased earnings by approximately $1.5 billion.

2. Relying on what it called "one-time actions," "one-offs," "accounting opportunities" and "accounting tricks" to achieve earnings targets that it otherwise could not have met, Xerox falsely portrayed itself as a business meeting its competitive challenges and increasing its earnings every quarter. Many of these accounting actions violated the established standards of generally accepted accounting principles ("GAAP"). All of them should have been disclosed to investors in a timely fashion because, singly and collectively, they constituted a significant departure from Xerox's past accounting practices and misled investors about the quality of the earnings being reported. The accounting actions improved Xerox's earnings, revenues and margins in each quarter and year during 1997 through 2000, and allowed Xerox to meet or exceed Wall Street expectations in virtually every reporting period from 1997 through 1999.

THE WALL STREET JOURNAL.

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DOWJONES VOL. CCXXXIII NO. 22 EE/PR ★★★ TUESDAY, FEBRUARY 2, 1999 INTERNET ADDRESS: http://wsj.com ... 75 CENTS

Keynes Mutiny

Why Is the Economist Passe, With So Much Of World in Recession?

Clinton Budget Is Latest Shift From Long-Held Belief In Deficits to Stir Economy

But IMF Backpedals in Asia

By Jacob M. Schlesinger
Staff Reporter of The Wall Street Journal
WASHINGTON—Keynes is dead. Long

What's News—

* * *

Business and Finance

CLINTON PRESENTED a $1.705 trillion budget that includes dozens of tax breaks and small spending increases. He spurned Republican calls for big tax cuts, marking the beginning of a coming debate over how to use budget surpluses. At the same time, the president proposed raising taxes on business and investors by $78.4 billion over the next five years. It's uncertain how much of Clinton's agenda will make it into law.

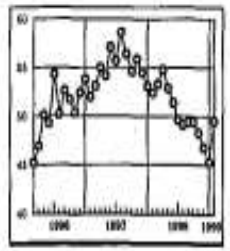
* * *

World-Wide

LEWINSKY'S TESTIMONY ISN'T expected to alter the course of Clinton's trial. Republicans privately acknowledged the former White House intern mostly affirmed prior testimony and generally appeared sympathetic to the president in questioning by House prosecutors. While House lawyers relentlessly their own questioning and read her an apologetic statement on Clinton's behalf. Senators are to receive a videotape of the session today. (Article on Page A24)

Clinton lawyers filed a complaint over a news report saying Starr may indict the president. Story is in Journal

Purchasing Management Index



PURCHASING MANAGEMENT Index, which monitors business activity within the manufacturing sector, rose to 49.5 in January from 45.3 in December, the National Association of Purchasing Manage-

Work Week

A Special News Report About Life On the Job—and Trends Taking Shape There

TUG-OF-WAR: More firms lose employees to the National Guard and Reserve.

The military reserves are calling up personnel more often these days, testing reservists' loyalty to their civilian employers. Reserve personnel served 13.3 million "man days" in fiscal 1998, up from 5.3 million in 1992. As the active military downsizes and units are deployed overseas, reservists are needed to fill in, says retired Rear Adm. Thomas F. Hall, executive director of the Naval Reserve Association. "That has put a strain on employers," he adds. "We worry about that."

Change Machine

Xerox Recasts Itself As Formidable Force In Digital Revolution

Copier Giant Is Battling A Challenge From Canon For Top of Office Market

Putting Label 'on Everything'

By Bernard Wysocki Jr.
Staff Reporter of The Wall Street Journal

And Xerox Chief Executive Paul Allaire, acknowledging Canon as a worthy opponent, points to Xerox's double-digit U.S. revenue growth, soaring profit and its array of new digital devices.

Was Enron a Criminal Case?

defense in a court of law. Here, the complaint does not mention the voucher program or reference the defendants' conduct in administering the voucher program. Rather, the claims pleaded in the complaint are based on a totally different course of conduct—HANO and HUD's actions leading up to demolition, the ultimate decision to demolish the buildings, and the demolition itself. These claims are not sufficient to put HANO and HUD on notice that they must defend the voucher program. Essentially, by defining the class based on treatment under the voucher program and limiting the class claims to those regarding the voucher program, the district court changed the nature of the lawsuit and rendered the complaint inadequate.

UNITED STATES of America, Plaintiff–Appellee,

v.

Jeffrey K. SKILLING, Defendant–Appellant.

No. 06–20885.

United States Court of Appeals, Fifth Circuit.

Jan. 6, 2009.

Background: Defendant, a senior company executive, was convicted in the United States District Court for the Southern District of Texas, Sim Lake, J., of conspiracy, securities fraud, making false representations to auditors, and insider trading, and he appealed.

The Prosecutors focused on relatively small misstatements

- Skilling's misstatements – impact on earnings
  - Segment reporting violation - $500 million
  - Reserves manipulation - $7 million
  - LJM transaction (Cuaiba) - $65 million
  - Nigerian barges sale - $12 million
  - Raptors - $500 million

Why did Enron sell Nigerian barges?

The second allegedly fraudulent secret side deal between Enron and LJM involved the sale of Nigerian barges.[6] The government claims that in the waning days of 1999, LJM warehoused assets for Enron, allowing Enron to claim earnings during 1999 while it arranged for permanent buyers after the end of the year. With respect to the Nigerian barges deal, in late 1999, Enron sought to sell its interest in a group of barges anchored off the coast of Nigeria to meet an earnings target at the end of the quarter. Most investors were nervous about putting money into Nigeria, so Enron could not find a buyer.

Why was this sale fraud by Skilling?

Skilling allegedly called Fastow into his office and asked for LJM to buy the barges, again saying he would "make sure" that LJM would not lose money. Fastow initially was reluctant, because he was trying to raise money for LJM and did not want to scare off investors. However, he told Skilling that LJM would purchase the

Internal Controls as a Response to Securities Fraud

- Public Company Accounting Oversight Board, Auditing Standard No. 5: Internal controls should scrutinize:
  - (1) “significant, unusual transactions, particularly those that result in late or unusual journal entries”;
  - (2) “journal entries and adjustments made in the period-end financial reporting process”;
  - (3) “related party transactions”;
  - (4) “significant management estimates” and
  - (5) “incentives for, and pressures on, management to falsify or inappropriately manage financial results.”

What motivates securities fraud?

- Unreasonably **high market expectations**
- Need to convey **predictability**
- Win at all costs **corporate culture**
- Deference to a successful and charismatic **founder**
- Excessive **stock compensation**

Generally Misleading: Pull Forwards

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 10940 / May 3, 2021

SECURITIES EXCHANGE ACT OF 1934
Release No. 91741 / May 3, 2021

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 4220 / May 3, 2021

ADMINISTRATIVE PROCEEDING
File No. 3-20278

In the Matter of **UNDER ARMOUR, INC.,** **Respondent.**

ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933 AND SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, AND IMPOSING A CEASE-AND-DESIST ORDER

3. For six consecutive quarters from the third quarter of 2015 through the fourth quarter of 2016 (the "Relevant Period"), Under Armour used pull forwards to help it meet analysts' revenue estimates. During the Relevant Period, Under Armour pulled forward approximately $408 million in orders. Under Armour's failure to disclose to investors the impact of its pull forward practices was misleading.[2] Without these pull forwards each quarter, Under Armour would have missed analysts' revenue estimates throughout the Relevant Period, and would have missed its better than 20% revenue growth streak in the fourth quarter of 2015 and the third quarter of 2016. On January 31, 2017, the day Under Armour announced that it missed analysts' revenue estimates for the fourth quarter and full-year 2016, the company's stock price dropped by approximately 23%. Under Armour's year-over-year growth rate for each quarter has remained in the single digits or negative since that time.

[2] This Offer does not make any findings that revenue from these sales was not recorded in accordance with generally accepted accounting principles ("GAAP").

The Future of Securities Fraud: ESG

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF NEW YORK

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

v.

VALE S.A.,

Defendant.

Civil Action No. 22-cv-2405

Complaint

Jury Trial Demanded

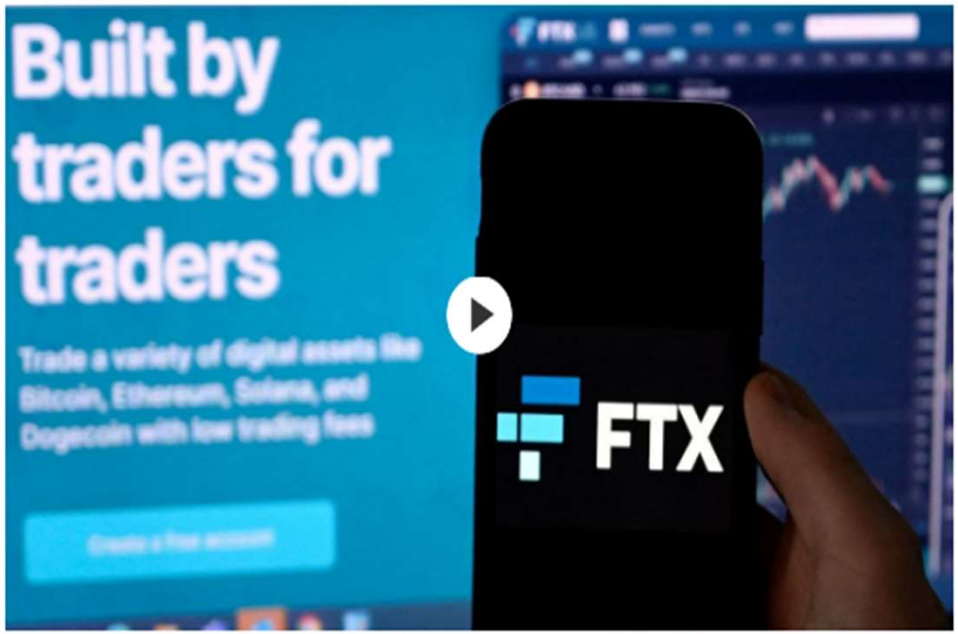
Plaintiff Securities and Exchange Commission ("Commission"), for its Complaint against Defendant Vale S.A. ("Vale") alleges as follows:

1. Vale, one of the world's largest iron ore producers, deceived investors concerning the safety and stability of dams that it built to hold waste from its mining operations. While taking full of advantage of the capital markets in the United States, Vale committed securities fraud by intentionally concealing the risks that one of its older and more dangerous dams, the Brumadinho dam, might collapse. Specifically, Vale (1) improperly obtained stability declarations for the dam by knowingly using unreliable laboratory data; (2) concealed material information from its dam safety auditors; (3) disregarded accepted best practices and minimum safety standards; (4) removed auditors and firms who threatened Vale's ability to obtain dam stability declarations; and (5) made false and misleading statements to investors.

MARKETS | CURRENCIES | CRYPTOCURRENCY

FTX Files for Bankruptcy, CEO Sam Bankman-Fried Resigns

Filing represents largest crypto-related bankruptcy ever



Cryptocurrency platform FTX filed for chapter 11 on Friday and CEO Sam Bankman-Fried resigned. WSJ's Vicky Ge Huang explains what happened to the company and what this could mean for investors. Photo: Olivier Douliery/AFP

By Caitlin Ostroff Follow , Vicky Ge Huang Follow and Alexander Gladstone Follow

Updated Nov. 11, 2022 6:43 pm ET

SAVE PRINT TEXT

COUNT FIVE
(Conspiracy to Commit Securities Fraud on Investors in FTX)

negative balance on FTX that BANKMAN-FRIED knew Alameda could not repay. Further, BANKMAN-FRIED concealed from both Alameda's lenders and FTX's equity investors the fact that Alameda had taken billions of dollars from FTX. And at relevant times, BANKMAN-FRIED required his co-conspirators and others who worked for him to communicate using encrypted and ephemeral messaging platforms that self-deleted, thereby preventing regulators and law enforcement from later obtaining a record of his misdeeds.

Misrepresentations

- FTX has a focus on “consumer protection” and had “principles for ensuring investor protections on digital asset-platforms” such as “avoiding or managing conflicts of interest”
- FTX “segregates consumer assets from its own assets across our platforms”

Commingling – FTX and Alameda

- FTX did not have a separate bank account where customer funds were deposited
- Alameda had access to the bank account where FTX funds were deposited and withdrew funds
- Alameda was permitted to have a negative balance in its FTX trading account
  - Sam Bankman-Fried directed personnel to change computer code to permit this

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

SECURITIES AND EXCHANGE COMMISSION, Plaintiff, v. TERRAFORM LABS PTE LTD. and DO HYEONG KWON, Defendants.	No. 1:23-cv-1346 JURY TRIAL DEMANDED

COMPLAINT

Terraform Ecosystem

31. In March 2018, Defendants began creating the Terraform ecosystem. Kwon and Terraform's co-founder published a white paper announcing the Terraform blockchain (referred to as the "Terra protocol") and the LUNA token, the first crypto asset created by Terraform. Eventually, the ecosystem would come to include a series of interconnected crypto assets whose purported adoption, liquidity, and value became highly dependent on the public's willingness to buy into Terraform and Kwon's blockchain empire.

Terraform and Securities Fraud

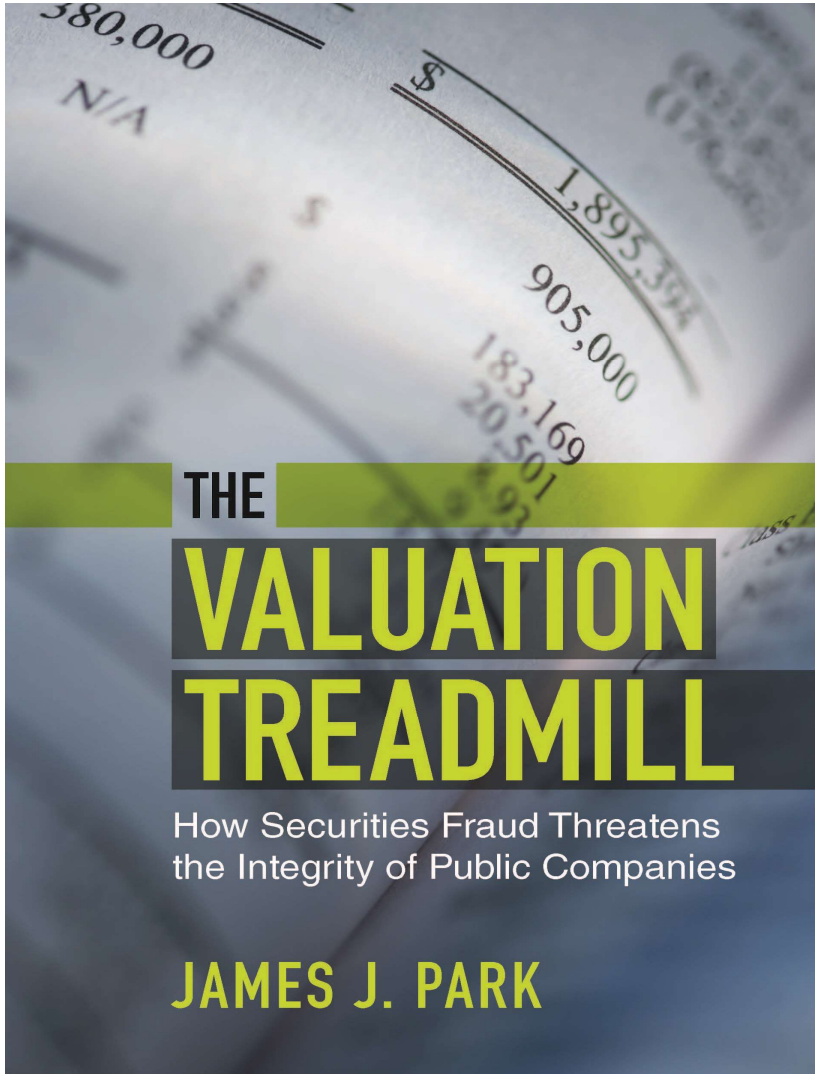
5. Defendants also engaged in a fraudulent scheme to mislead investors about the Terraform blockchain and its crypto asset securities. Terraform and Kwon repeatedly – and falsely – told the investing public that a popular Korean electronic mobile payment application called "Chai" employed the Terraform blockchain to process and settle commercial transactions between customers and merchants. If true, this would have been a breakthrough for the Terraform blockchain, a supposed real-world use that could increase the value of LUNA as demand for the token rose in connection with increased use of the Terraform blockchain. Investors bought in, purchasing LUNA and other Terraform crypto assets, based in part on Terraform's and Kwon's claims that Chai payment transactions were being processed and settled on the Terraform blockchain. But in reality, Chai payments did not use the Terraform blockchain to process and settle payments. Rather, Defendants deceptively replicated Chai

Fake Record of Transactions

134. To carry out this deception, Terraform programmed a server, which was referred to internally as the "LP Server," to receive and process data about Chai transactions, and then issue instructions to the Terraform blockchain to replicate those transactions as if they had originally "settled" on the Terraform blockchain.

Where to Find the Book?

- Amazon
  - The Valuation Treadmill: Park, James J.: 9781108940412: Amazon.com: Books
- Barnes and Noble
  - The Valuation Treadmill: How Securities Fraud Threatens the Integrity of Public Companies by James J. Park, Paperback | Barnes & Noble® (barnesandnoble.com)
- Cambridge University Press
  - Valuation treadmill how securities fraud threatens integrity public companies | Corporate law | Cambridge University Press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