

Memorandum

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Federal District Court Holds That SEC Action For Aiding And Abetting Under Exchange Act Section 20(e) Requires "Actual Knowledge"

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Last month's landmark U.S. Supreme Court decision in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761 (Jan. 15, 2008), which substantially narrowed the ability of private plaintiffs to sue secondary actors for federal securities fraud, led many observers to speculate whether the U.S. Securities and Exchange Commission (.SEC.) would try to fill the potential enforcement void created by the decision. *Stoneridge* made clear that it did not limit the power of the SEC to bring cases against secondary actors. Among other things, unlike private plaintiffs, the SEC has specific statutory authority under section 20(e) of the Securities Exchange Act of 1934 ("Exchange Act"), as added to by the Private Securities Litigation Reform Act of 1995, 15 U.S.C. § 78u-4 et seq. ("PSLRA"), to sue secondary actors in federal court for "aiding and abetting" a securities fraud.

However, a recent district court decision in the District of Columbia - decided the day after *Stoneridge* - suggests a trend towards tightening the standards that the SEC must meet to prevail on such aiding and abetting claims. On a motion for summary judgment in *SEC v. Johnson*, Civ. Action No. 05-36 (GK) (D.D.C. Jan. 16, 2008), the district court, though denying defendant's motion, rejected the SEC's contention that the minimum scienter or state of mind for an aiding and abetting claim under section 20(e) is "extreme recklessness." Rather, the court required the SEC to show "actual knowledge."

JOHNSON FACTUAL BACKGROUND

The *Johnson* case involved an executive at America Online, Inc. ("AOL"), Kent Wakeford. According to the district court, AOL had entered into a series of three-party agreements with PurchasePro and AuctionNet in which a AOL was to pay PurchasePro in quarterly installments for work that required integration of AuctionNet into PurchasePro and AOL websites. The heart of the primary violation, according to the SEC's complaint, was an allegedly sham Statement of Work that supposedly demonstrated that PurchasePro had completed certain integration work sufficient to entitle it to payment of \$3.65 million. PurchasePro used this payment to inflate its reported revenue for the first quarter of 2001.

The SEC argued that Wakeford aided and abetted PurchasePro's asserted violation. The SEC presented evidence that Wakeford had devised the scheme that would permit the allegedly improper revenue recognition and then had taken steps to

implement it. For example, the SEC pointed to testimony suggesting that the creation of a Statement of Work was Wakeford's idea after he was made aware that PurchasePro was searching for ways to meet its quarterly revenue projections. There was also evidence that Wakeford subsequently instructed another AOL executive to certify to PurchasePro's auditors that the work set forth in the Statement of Work had been completed when Wakeford knew that it had not been completed.

LEGAL ISSUE POSED IN *JOHNSON*

The parties in *Johnson* agreed that the SEC was required to prove three elements to establish aiding and abetting liability under section 20(e): (i) that a principal has committed a primary violation; (ii) that the aider and abettor has provided "substantial assistance" to the primary violator; and (iii) that the aider and abettor acted with "scienter." The parties disagreed as to what state of mind is needed to satisfy the element of scienter.

THE DISTRICT COURT'S DECISION

The *Johnson* court rejected the SEC's argument that it need only show recklessness to prove scienter. It held instead that the SEC must show that a defendant acted with actual knowledge of wrongdoing. In reaching that conclusion, the court looked to the language of section 20(e), which specifies that: "any person that knowingly provides substantial assistance to another person in violation of a provision of this title, or any rule or regulation issued under this title, shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided." The court noted that another provision of the Exchange Act, also added by the PSLRA, expressly defines "knowingly" as requiring "actual knowledge."

Based on the evidence presented, the court found that the SEC had showed a triable issue of fact on the matter of Wakeford's "knowing" misconduct. As a result, the court denied defendant's motion for summary judgment on the SEC's aiding and abetting claims.

SIGNIFICANCE OF *JOHNSON*

Johnson is the second district court decision in the past two years to conclude that the SEC must show "actual knowledge" to prove an aiding and abetting violation under section 20(e). The other is *SEC v. KPMG LLP*, 412 F. Supp. 2d 349, 382-83 (S.D.N.Y. 2006). *Johnson* and *KPMG* may represent a trend away from earlier cases that had constructed section 20(e) to encompass recklessness, at least in certain circumstances. See, e.g., *SEC v. PIMCO Advisors Fund Management LLC*, 341 F. Supp. 2d 454, 468 (S.D.N.Y. 2004); *SEC v. Lybrand*, 200 F. Supp. 2d 384, 399-400 (S.D.N.Y. 2002).

If this trend continues among district courts and the courts of appeals follow their lead, the SEC will confront a higher bar when it sues secondary actors in district court than when it sues regulated persons for aiding and abetting in an administrative proceeding brought under section 15 or section 21B of the Exchange Act. Those sections of the Exchange Act authorize the SEC to discipline or seek penalties against regulated persons who "willfully" aid and abet violations of the securities laws. In such administrative proceedings, the courts are in agreement that a showing of recklessness - not actual knowledge of wrongdoing - is sufficient to establish that a regulated person willfully aided or abetted another's violation.



QUESTIONS

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