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AN EXAMINATION OF THE SEC'S EFFORTS TO CHARGE PERIPHERAL PLAYERS WITH SECURITIES FRAUD

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by
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I. Introduction

The Securities and Exchange Commission ("SEC") serves many functions, including its stated goal to enforce compliance with Federal securities laws.[2] The SEC's primary method of enforcing the Federal securities laws is through its power to investigate fraud and to impose fines and other sanctions in administrative and civil enforcement actions.[3] The SEC reports that it has "successfully resolved" an astounding percentage of its enforcement actions.[4] For example, in the years 2005, 2006 and 2007, the SEC reported that it successfully resolved 99%, 99% and 92%, respectively, of the enforcement actions it filed.[5]

This article focuses on an important segment of those enforcement actions where the SEC failed to obtain a favorable result.[6] In these actions, the SEC attempted – unsuccessfully – to extend 10b-5 liability to an expanded group of parties, including lower level management employees and non-decision making individuals – or "peripheral" players. The purpose of this article is to review the grounds on which courts have rejected the SEC's efforts.

II. Examination of Enforcement Actions Against Peripheral Players

A. Actions Dismissing Peripheral Players at the Pleading Stage

The following SEC enforcement actions were dismissed at the pleading stage for failure to state a claim

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2 *See* U.S. Securities and Exchange Commission 2007 Performance and Accountability Report, www.sec.gov/about/secpar/secpar2007.pdf ("2007 Annual Report").

3 In 2007 the SEC initiated 656 enforcement actions. 2007 Annual Report, pg. 25.

4 *Id.*, pg. 27, Table 2.2, defining "successfully resolved" as actions where the SEC received a favorable judgment, a settlement, or the issuance of a default judgment.

5 *Id.*; *see also* U.S. Securities and Exchange Commission 2006 Performance and Accountability Report, pg. 43, Exhibit 2.2, www.sec.gov/about/secpar/secpar2006.pdf and U.S. Securities and Exchange Commission 2005 Performance and Accountability Report, pg. 38, Exhibit 2.4, www.sec.gov/about/secpar/secpar2005.pdf.

6 The authors reviewed decisions over the past three years where defendants' roles in the alleged fraudulent conduct were described in sufficient detail to permit analysis.

for securities fraud. In these actions, the SEC charged peripheral players as primary and secondary violators of the alleged fraudulent activity. The peripheral players charged included a salesperson, a merchandiser, a consultant and other lower-level employees. In dismissing the SEC's claims, the courts consistently held that the SEC failed to allege critical elements of a securities fraud violation, including the failure to allege a misrepresentation of a material fact that could be imputed to the individual defendants and/or the failure to allege the requisite scienter.

In *SEC v. Lucent Technologies, Inc.*, 2005 U.S. Dist. LEXIS 41713 (D.N.J. 2005), the SEC alleged that Lucent Technologies Inc. ("Lucent") fraudulently and improperly recognized revenue in violation of GAAP during its fiscal year 2000. The SEC sued, among others, Alice Dorn ("Dorn"), Lucent's vice president of sales, alleging that she concealed verbal side agreements from and made misrepresentations to Lucent's finance department.[7]

In dismissing the SEC's primary and secondary claims, the Court held that "[t]here are no allegations from which the Court could infer that Dorn had any knowledge of accounting principles or that she had any role in Lucent's decisions to recognize revenue in connection with the transactions Dorn executed."[8] The Court rejected the SEC's assertion that Dorn need not be an accountant to appreciate that the side agreements would lead to improper revenue recognition, holding that "the SEC offers no compelling reason why this Court should charge regular business people with knowledge of accounting principles."[9]

SEC v. Tambone, 417 F. Supp. 2d 127 (D. Mass. 2006), is another example of where the SEC failed to expand 10b-5 liability to peripheral players. In *Tambone*, the SEC alleged that defendants violated, among other securities laws, Section 10(b) and Rule 10b-5 by entering into, approving and knowingly permitting arrangements allowing certain preferred customers to engage in market timing in Columbia funds.[10] The defendants were distributors whose primary responsibility was to sell the Columbia funds to clients and potential clients.[11]

In dismissing the SEC's complaint, the Court held that the SEC failed to allege that defendants made any untrue or misleading statements:

> There is no evidence here that the defendants disseminated any allegedly misleading prospectus. Although the complaint alleges that Columbia Distributor disseminated the prospectuses for the Columbia Funds, that does not implicate the defendants' personal liability for securities fraud as primary actors. The SEC's complaint simply alleges that the defendants 'used [the misleading fund prospectuses] in offering and selling the funds directly or indirectly to clients and potential clients' but does not assert that they controlled, supervised or played any role in the distribution of the prospectuses.[12]

In addressing the SEC's aiding and abetting claims, the Court similarly held that the SEC failed to plead that defendants had "actual knowledge" of the improper activity of the primary violators or that they possessed the "conscious intent" necessary for their inaction to qualify as knowing and substantial assistance.[13]

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7 *Lucent Technologies*, 2005 U.S. Dist. LEXIS 41713, at *3-5.
8 *Id.*, at *14.
9 *Id.*, at *16.
10 *Tambone*, 417 F. Supp. 2d at 129-130.
11 *Id.* at 129.
12 *Id.* at 133-34.
13 *Id.* at 137.

In an effort to correct its deficiencies, the SEC filed an amended complaint containing two new paragraphs alleging, "upon information and belief," that the defendants exchanged e-mails with in-house counsel for Columbia Advisors regarding draft language on market timing for a 2001 prospectus.[14] The Court found these allegations equally unavailing. The Court also expressed frustration with the SEC's argument that it was unable to state its allegations with greater detail because the e-mails in question were being withheld by defendants as subject to the attorney/client privilege.

> The fact that the information is subject to privilege, however, does not relieve the SEC of its burden to allege fraud with particularity. . . . The SEC contends that it would, during discovery, inquire further as to the nature of the e-mails and other communications that the defendants may have exchanged with in-house counsel regarding the draft prospectus language. While the SEC is not strictly limited to information gathered during its investigation prior to filing a complaint, (citation omitted), the SEC's position suggests that it is merely guessing as to the contents of the e-mails in question.[15]

In *SEC v. Roanoke Technology Corp.*, 2006 U.S. Dist. LEXIS 92995 (M.D. Fla. 2006), the SEC attempted to extend 10b-5 liability to Barrett Clark ("Clark"), a consultant to the defendant company. The SEC alleged that Clark participated in defendants' alleged "pump and dump" scheme because he received Roanoke stock, purportedly as payment for consulting services, sold the shares, and returned a portion of the sales proceeds to the other defendants in the form of a loan.[16] In dismissing the SEC's complaint against Clark, the Court held that:

> [t]he SEC does not allege that Clark was even aware of the false public statements [the defendants] made to inflate Roanoke's stock, much less that Clark made such statements himself.[17]

Like it had done in *Tambone II*, the SEC attempted to correct these pleading deficiencies by filing an amended complaint.[18] The Court, however, again found that the SEC failed to state a claim against Clark because it failed to allege that Clark made any false public statements or was aware of any such statements.[19] The Court also held that the SEC's allegations relating to materiality and Clark's scienter were insufficient.[20]

In *SEC v. Durgarian*, 477 F. Supp. 2d 342 (D. Mass. 2007), the SEC filed Section 10(b) and Rule 10b-5 claims against peripheral employees of Putnam Fiduciary Trust Company ("Putnam"), including Putnam's former plan administrator, Kevin Crain ("Crain"), Putnam's former director of the Defined Contribution Plan Servicing unit, Virginia Papa ("Papa"), and Putnam's former vice president in the new business implementation unit, Sandra Childs ("Childs"). The SEC alleged that the individual defendants devised a plan to backdate purchase orders from a customer in order to conceal the fact that Putnam delayed placing the orders, costing the customer millions of dollars.[21] In dismissing the SEC's claims against Crain, Papa and Childs, the Court held that:

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[14] *SEC v. Tambone*, 473 F. Supp. 2d 162, 166 (D. Mass. 2006).
[15] *Tambone II*, 473 F. Supp at 166, 167 n.1.
[16] *Roanoke*, 2006 U.S. Dist LEXIS 92995, at *2.
[17] *Id.*, at *14.
[18] *SEC v. Roanoke Technology Corp.*, 2006 U.S. Dist. LEXIS 59835 (M.D. Fla. 2006).
[19] *Roanoke II*, 2006 U.S. Dist. LEXIS 59835, at *9-10.
[20] *Id.*, at *10-16.
[21] *Durgarian*, 477 F. Supp. 2d at 346.

> beyond their attendance at the January, 2001 meeting, the Complaint identifies no explicit acts taken by defendants Crain, Papa and Childs . . . in furtherance of the fraudulent scheme . . . . While the other defendants are named for their roles in devising, approving or implementing the scheme, the Complaint makes only vague allusions regarding the involvement of these defendants. [The individuals] persuasively contend that the SEC has inappropriately lumped them together with the other three defendants and that the generalized allegation of attending a meeting is insufficient to demonstrate substantial participation in the alleged scheme.[22]

In *SEC v. Orr*, 2006 U.S. Dist. LEXIS 11447 (E.D. Mich. 2006), the Court once again rejected the SEC's attempts to charge a peripheral player, in this case a merchandiser, with securities fraud. In Orr, the SEC alleged that a number of Kmart Corporation ("Kmart") employees and vendors participated in schemes that led to Kmart overstating its revenues and understating its expenses.[23] Defendant Paul Orr ("Orr") was a former Kmart merchandiser and vice president whose primary responsibility was to decide which film and camera products and services to offer in the retail stores and how to display them. The SEC alleged that several vendor allowances in 1999 and 2000 were improperly pulled forward at Orr's direction.[24]

In dismissing the claim against Orr for a primary violation of Section 10(b) and Rule 10b-5, the Court found that "there are no allegations with respect to any of the allowances that he allegedly pulled forward [or] that he was directly involved in the preparation or issuance of the Form 10-K for the 1999 or 2000 fiscal years."[25] The Court concluded that the fact that Orr directed others to execute transactions that were incorporated into Kmart's Form 10-Ks did not result in a primary violation of Section 10(b) or Rule 10b-5.[26]

B. Actions Where Judgment Entered in Favor of Peripheral Players

The following two enforcement actions brought by the SEC were dismissed on summary judgment and on motion for judgment as a matter of law following a bench trial. In these two actions, the SEC attempted to charge a consultant and assistant controller, respectively, as primary and secondary violators of the alleged fraudulent activity. In entering judgment in favor of these individuals, the courts held that the SEC failed to prove critical elements of a securities fraud violation, including the failure to prove a misrepresentation of a material fact that could be imputed to these individuals and/or the failure to prove the requisite scienter. In one of the actions, the court went so far as to award the defendant his fees, finding that the SEC's action was not substantially justified.

In *SEC v. Cedric Kushner Promotions, Inc.*, 417 F. Supp. 2d 326 (S.D.N.Y. 2006), the SEC asserted various securities law violations against Cedric Kushner Promotions, Inc. ("CKP") and numerous individual defendants, including Steven Angel ("Angel"), a CKP consultant hired to address issues relating to a recent merger CKP had completed. On May 20, 2003, CKP filed its 2002 Form 10-KSB with the SEC. The Form 10-KSB allegedly contained misrepresentations and omissions, including incorrect statements of CKP's cash flows, operating expenditures and number of shares outstanding. The May 20 filing also contained audit reports that had been included by CKP without the

22 *Id.* at 354.
23 *Orr*, 2006 U.S. Dist. LEXIS 11447, at *2.
24 *Id.*, at *13.
25 *Id.*, at *33.
26 *Id.*

consent of its auditors, and had computer signatures of the auditors that were, in effect, forged. Angel moved for summary judgment on the SEC's primary and secondary claims.[27]

In granting Angel's summary judgment motion, the Court found that Angel played a "very background role" in the preparation of the May 20 filing.[28] Angel's role in preparing the filing was limited to providing "paper work backup" documentation to CKP's CFO and outside auditors and answering questions about pending litigation against CKP.[29] The Court stated as follows:

> Angel had literally no involvement in the falsifications. He did not prepare the financial figures, did not assist in the preparation of these figures, did not review these figures, and had no responsibility or authority to take any such steps or actions. As to the false signatures of the auditors, Angel had nothing to do with such falsification.[30]

Similarly, the Court granted summary judgment in Angel's favor on the SEC's aiding and abetting claim. The Court rejected the SEC's general assertions that Angel must have known of material misstatements because his duties as a consultant included compliance and SEC filings and that Angel communicated with members of the CKP team that prepared, reviewed and made SEC filings.[31] "[T]hese assertions about general practices within the company are of no weight in view of the admitted particular facts about what Angel did and did not do with regard to the SEC form at issue in the present case."[32]

Notably, Angel was awarded his attorneys' fees and costs against the SEC under the Equal Access to Justice Act ("EAJA").[33] Under the EAJA, a court may award a prevailing party fees and expenses in any action brought by or against the United States if the court finds that the position of the United States was not substantially justified. In awarding Angel his fees against the SEC, the Court found that the SEC's position was not substantially justified because the SEC presented facts against Angel that were "grossly insufficient" and "unreasonable."[34]

In *SEC v. Guenthner*, 395 F. Supp. 2d 835 (D. Neb. 2005), the SEC asserted violations of Section 10(b) and Rule 10b-5 and records violations against the defendants, including defendant Jay Samuelson, the assistant corporate controller of InaCom Corporation ("InaCom"). The SEC alleged that defendants committed fraud by causing InaCom to overstate its earnings for the third quarter of 1999.[35] Following a bench trial, the Court granted defendants' motions for judgment as a matter of law. The Court concluded that:

> [t]here has been a complete and utter failure of proof by the Commission. The Commission has failed to prove any of the elements of its securities fraud claims. Most notably, the Commission has not shown that Guenthner or Samuelson made any misstatements or misrepresentations in InaCom's third-quarter 1999 filings.[36]

With respect to scienter, the Court found that:

27 *Cedric Kushner, 417 F. Supp. 2d at 327.*
28 *Id.* at 329.
29 *Id.*
30 *Id.* at 332.
31 *Id.* at 335.
32 *Id.*
33 *SEC v. Cedric Kushner Promotions*, Inc., 2006 U.S. Dist. LEXIS 32846 (S.D.N.Y. 2006).
34 *Cedric Kushner II*, 2006 U.S. Dist. LEXIS 32846, at *10-11.
35 *Guenthner*, 395 F. Supp. 2d at 838.
36 *Id.* at 847.

> [n]o evidence of any indicia of scienter was presented. The evidence shows only that InaCom suffered a business reversal largely due to circumstances beyond its control in the rapidly evolving and highly competitive technology market. . . . The Commission has, at most, shown mismanagement or marginal negligence in accounting, but has not shown securities fraud.[37]

III. Conclusion

The SEC has extraordinary powers and resources to investigate conduct and to determine if it has a reasonable basis to charge individuals with securities fraud. Unlike private parties in civil actions, the SEC can exercise these powers and utilize these resources before it files a complaint. For example, the SEC can subpoena documents and compel individuals to testify during the investigatory phase. In light of the SEC's pre-filing powers and resources, it is difficult to understand why the SEC would exercise its discretion to assert factually deficient securities fraud claims against peripheral players under circumstances such as are described above. In light of the devastating impact that the mere assertion of a securities fraud claim has on an individual's reputation and financial well-being, the SEC should proceed with greater caution when it determines whether or not to brand a peripheral player a fraud.

[37] *Id.* at 848.