Scienter and Section 20(e): A New Consensus on Aiding and Abetting Liability in SEC Enforcement Actions

By David S. Slovick[1]

Over the past decade, most federal district court actions filed by the Securities and Exchange Commission to redress acts of corporate fraud have contained a familiar roster of alleged federal securities laws violations. Chief among these are the anti-fraud provisions themselves—in the usual case, Section 10(b) of the Securities Exchange Act and Rule 10b-5 promulgated thereunder, and Section 17(a) of the Securities Act, in either its scienter-based (17(a)(1)) or non-scienter-based (17(a)(2) and (3)) form. Most such cases seek a familiar combination of statutory, administrative, and equitable remedies as well, including equitable disgorgement of ill-gotten gains, civil monetary penalties, and bars prohibiting defendants from serving as officers or directors of public companies or appearing before the Commission as accountants or lawyers.

Nearly as common today as actions for direct violations of the anti-fraud provisions are actions based on secondary, or aiding and abetting, liability attendant to direct violations. While the law addressing the principal elements of primary liability under the Securities Act and Exchange Act is reasonably well settled, aiding and abetting liability has been the subject of much debate in the courts over the past decade, due in part to (comparatively) new Supreme Court authority governing such actions and new federal legislation. A perennial subject of dispute concerns the appropriate mental state requirement in aiding and abetting cases brought pursuant to Section 20(e) of the Exchange Act, which

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codified the SEC's ability to bring aiding and abetting claims. A number of recent decisions, however, appear to have established a new consensus concerning the proper mental state requirement in Section 20(e) actions. The following is an overview of those decisions and their antecedents.

AIDING AND ABETTING LIABILITY IN SEC ENFORCEMENT ACTIONS BEFORE 1995

Prior to the enactment of the Private Securities Litigation Reform Act of 1995 ("PSLRA"), courts were given little legislative guidance on the proper mental state requirement to be applied in civil aiding and abetting actions, either private or governmental. The case law addressing the issue was in disarray as a result. As one court put it in 1980, although the elements of an aiding and abetting claim were "commonplace, the exact content of the rather vague phrases, especially 'knowledge' and 'substantial assistance', is still being delineated by the courts."[2] The Second Circuit, for example, employed a two-step analysis that turned on the fiduciary status of the alleged aider-abettor:

> Whether a reckless disregard of the facts is sufficient to satisfy the requirement of knowledge [in an aiding and abetting claim] has not yet been decided by the Supreme Court. However, in the Second Circuit, if the alleged aider and abettor owes a fiduciary duty to the plaintiff, recklessness is enough. If there is no fiduciary duty, the "scienter" requirement scales upward—the assistance rendered must be knowing and substantial.[3]

Other courts, including the Ninth Circuit, opted for a less nuanced approach that adopted wholesale the definition of scienter used to analyze direct violations of the anti-fraud provisions—actual knowledge or recklessness.[4] Still other courts insisted that plaintiffs prove actual knowledge, as opposed to mere reckless disregard, of an underlying securities law violation to sustain an aiding and abetting claim. In *Walck v. American Stock Exchange*, for example, the Third Circuit affirmed dismissal of plaintiff's claim for aiding and abetting Section 10(b) violations because "nothing in the complaint alleges that the [defendants] knew of the wrong, as required by our formulation of the elements of aider-abettor liability …."[5]

In 1994, the Supreme Court granted certiorari in *Central Bank of Denver v. First Interstate Bank of Denver* to resolve, among other issues, the disagreement among the lower courts over the proper mental state requirement in aiding and abetting cases.[6] The opinion the Court ultimately issued turned out to be of little use in that regard because the Court determined that no private right of action for aiding and abetting existed in the first place, and so did not reach the metal state issue. The Court's opinion did not, however, foreclose

aiding and abetting claims brought by the SEC, and thus left unchanged the case law governing the proper mental state requirement in such cases. That is, *Central Bank* did nothing to clear up the confusion surrounding scienter in aiding and abetting cases brought by the SEC.

Congress weighed in the following year with the PSLRA, legislation enacted to correct perceived abuses in private securities class action litigation stemming from "frivolous 'strike' suits alleging violations of the Federal securities laws …."[7] According to the Senate Banking Committee that helped craft the legislation, such suits, which are designed principally to force quick settlements, are unusually pernicious because they "unnecessarily increase the cost of raising capital and chill corporate disclosure, [and] are often based on nothing more than a company's announcement of bad news, not evidence of fraud."[8] As part of its effort to curb such suits, Congress also amended the Securities Exchange Act to address the Supreme Court's then-recent decision in *Central Bank*, which, as discussed above, foreclosed a private right of action for aiding and abetting violations of the securities laws.[9]

While Congress ultimately declined to upset *Central Bank*'s holding prohibiting private aiding and abetting claims (because such claims often run counter to the remedial goals of the legislation), it used the PSLRA to "clarify[] the ability of the SEC to bring aiding and abetting claims."[10] This clarification was embodied in a new sub-section of the Exchange Act, 20(e), which provides, "[f]or purposes of any action brought by the Commission under paragraph (1) or (3) of Section 21(d) of [the Exchange Act], any person that knowingly provides substantial assistance to another person in violation of a provision of this title, or of 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."[11] Courts interpreting Section 20(e) have generally agreed that it consists of three elements: (1) a securities law violation by a primary wrongdoer, (2) "knowledge" of the violation by the defendant, and (3) substantial assistance by the aider-abettor in the primary violation.[12]

Even after the enactment of the PSLRA, however, the appropriate mental state requirement for aiding and abetting claims remained unclear. As was the case before the PSLRA, possible options included actual knowledge, a traditional recklessness standard (well established in securities fraud jurisprudence), and some hybrid of the two, such as "severe recklessness." The plain language of Section 20(e) seems to recommend the higher standard: it states that no liability can be assessed absent knowledge on the part of the defendant of the wrongful nature of her actions. Although the term "knowingly" is not explicitly defined in Section 20(e), it is defined as "actual knowledge" elsewhere in the same statute in which Section 20(e) appears and therefore

presumably has the same meaning.[13] As one court observed when interpreting Section 20(e), "'[i]dentical words used in different parts of the same act are intended to have the same meaning.'"[14]

This interpretation finds further support in the legislative history. In the section of the Senate Banking Committee's Report on the PSLRA detailing the "purpose and scope of the legislation," the Committee clarified that the scope of Section 20(e) was intended to be limited to "actions seeking injunctive relief or money damages against persons who knowingly aid and abet primary violations of the securities laws."[15] Elsewhere in the Report the Committee noted that "Section 108 [of the PSLRA] amends Section 20 of the 1934 Act by adding a new subsection (e), authorizing the SEC to bring an action seeking injunctive relief or money penalties against persons who knowingly 'aid and abet' primary violators of the securities laws."[16] That the term "knowingly" was used advisedly in both the legislation and the Senate Banking Committee's Report is further evidenced by an addendum to the Committee's Report authored by Senators Sarbanes, Bryan and Boxer, which observed that "[t]he bill reported by the Committee restores, in part, the SEC's ability to sue parties who aid and abet violations of the securities laws. The provision in the bill is limited to violations of Section 10(b) of the Securities Exchange Act, and to individuals who act 'knowingly'."[17] That is, consistent with the language of the final legislation, the legislative history of the Senate's version of the bill appears to have intentionally employed the term "knowingly" when defining the type of conduct Section 20(e) was intended to reach.

In fact, during the floor debates on the legislation, the Senate expressly considered and rejected an amendment to Section 20(e) that would have allowed the SEC to maintain an aiding and abetting claim based on a showing of mere recklessness. As Judge Denise L. Cote explained in her opinion in *SEC v. KPMG*, which carefully considered the scope of aiding and abetting liability in the wake of the PSLRA,

> [t]he record of the Senate debate clearly indicates that the legislators understood the import of the bill's language. Senator Bryan, the sponsor of the amendment [incorporating a recklessness standard into Section 20(e)] (the "Bryan Amendment") recognized: "Although [the existing bill] authorizes the SEC to take action against aiders and abettors who knowingly violate the securities laws, it effectively eliminates the ability of the [SEC] to proceed against reckless professional assisters."[18]

In sum, the legislative history—both the Senate Banking Committee's Report and the actual floor debates—establish that the Senate's overt intent in enacting Section 20(e) was not only to preserve the SEC's ability to pursue

aiding and abetting claims after *Central Bank*, but also to clarify the mental state requirement for such actions and foreclose aiding and abetting claims based on merely reckless conduct.

POST-PSLRA CASE LAW

Despite the apparently straightforward statutory language and legislative history of the PSLRA, after the legislation was enacted courts remained split over the proper mental state requirement in SEC aiding and abetting actions. One early decision by the Ninth Circuit in *SEC v. Fehn*, which is still regularly cited today, came down squarely in favor of the higher standard: "[w]e acknowledge that other decisions by this Court have defined [the scienter] element [of an aiding and abetting claim] as 'actual knowledge *or* reckless disregard'…. We do not address this discrepancy because Section 104 [of the PSLRA], by its plain terms, requires 'know[ledge]' as an element of aiding and abetting."[19] Surveying the state of aiding and abetting law nearly ten years after the passage of the PSLRA, however, another court observed:

> Courts generally have held that in the absence of a duty of disclosure, a defendant should be held liable as an aider and abettor only if the plaintiff proves that the defendant had actual knowledge of the improper activity of the primary violator and of his role in that activity. Where the defendant has a duty to disclose the primary violations, however, courts have been willing to impose liability on the basis of a recklessness standard.[20]

But even that assessment fails to capture the variety of formulations employed by courts after the PSLRA was enacted. For example, in a 2002 decision in *SEC v. Lybrand*, Judge Sidney H. Stein of the District Court for the Southern District of New York intimated that recklessness suffices to sustain a Section 20(e) claim where a fiduciary relationship exists, or "where the plaintiffs were third parties whose reliance on the defendant's fraudulent conduct was foreseeable or where the defendant owed a duty of disclosure to the defrauded party."[21] Similarly, but not identically, in *SEC v. Peretz,* Judge Patti B. Saris of the District Court for the District of Massachusetts acknowledged the new standard established by the PSLRA but nonetheless "look[ed] to the pre-*Central Bank* test for whether a defendant is liable as an aider and abettor of a violation of § 10(b)" and held that recklessness suffices to prove an aiding and abetting claim "[w]here the defendant has a duty to disclose the primary violations …."[22] By contrast, in *SEC v. Lucent Technologies, Inc*., a May 2005 decision, Judge William H. Walls of the District Court for the District of New Jersey held that the SEC failed to state a claim for aiding and abetting a Section 10(b) violation because "no facts have been alleged …

that would suggest that [the defendant] knowingly participated in Lucent's misstatement of revenue and income."[23] Although the court couched its decision in terms of the SEC's failure to satisfy the "substantial assistance" element of an aiding and abetting claim, at issue was the SEC's failure to allege facts demonstrating defendant's "knowledge."

RECENT DECISIONS: A NEW CONSENSUS

Beginning with Judge Cote's January 2006 decision in *SEC v. KPMG* and continuing with decisions issued earlier this year, however, courts have begun to reach a consensus on the proper mental state requirement in SEC actions brought pursuant to Section 20(e), at least in those cases where the underlying primary securities violation itself requires proof of scienter.[24] As discussed above, in *KPMG* Judge Cote "rejected" the SEC's argument "that Section 20(e) encompasses recklessness in addition to actual knowledge."[25] Her decision was based largely on the language and legislative history of Section 20(e) and the "lack of uniformity" in pre-PSLRA aiding and abetting law, which, she reasoned, Congress "was aware of … when it passed Section 20(e)."[26] Subsequent decisions have begun to incorporate this reasoning and have, as a result, reached the same conclusions as Judge Cote with increasing regularity.

For example, following close on the heels of *KPMG* Judge Thomas P. Griesa of the District Court for the Southern District of New York issued a decision in *SEC v. Cedric Kushner Promotions, Inc*. dismissing an SEC claim for aiding and abetting violations of Section 10(b) of the Exchange Act for failure to allege the correct mental state.[27] In rejecting the SEC's assertion that recklessness suffices to sustain such claims, the court agreed with the holding of *KPMG* "that knowing misconduct must now be shown" to maintain an aiding and abetting claim, for fiduciaries and non-fiduciaries alike.[28] Similarly, in March 2006, Judge John C. Coughenour of the District Court for the Western District of Washington, relying on the Ninth Circuit's decision in *SEC v. Fehn*, held that "the PSLRA differed from pre-*Central Bank* jurisprudence in one significant way—expressly requiring 'knowledge' as an element of aiding and abetting, rather than permitting reckless disregard to support an aiding and abetting claim."[29]

More recently, in September 2008, Judge Richard J. Holwell, also of the Southern District of New York, granted in part defendants' motion to dismiss the SEC's aiding and abetting allegations in *SEC v. Espuelas*.[30] There, the SEC alleged that certain officers of Internet company StarMedia and its subsidiaries aided and abetted the company's violations of Sections 10(b), 13(a), and 13(b)(2)(A) of the Exchange Act, and Section 17(a) of the Securities Act, by assisting StarMedia in improperly recognizing revenue in the last three quarters of 2000 and the first two quarters of 2001.[31] Acknowledging

the "split of authority in [the Southern District of New York] as to whether Section 20(e) encompasses recklessness in addition to actual knowledge," Judge Holwell summarized Judge Cote's reasoning in *KPMG* and, like her, determined that Congress intended to abolish a recklessness standard in actions brought pursuant to Section 20(e).[32] In so holding, Judge Holwell distinguished those decisions issued before the enactment of the PSLRA that adopt a recklessness standard because they conflict with "the PSLRA's text, structure and legislative history …."[33]

Similarly, in June 2008, Judge Joel A. Pisano of the District Court for the District of New Jersey issued a decision in *SEC v. Pasternak* which held, following *Fehn*, that the proper mental state requirement in an SEC action brought pursuant to Section 20(e) is actual knowledge—as opposed to mere reckless disregard—of a primary securities law violation.[34] *Pasternak* arose from an alleged front running scheme by a trader employed by registered broker-dealer Knight Securities, L.P. According to the SEC's complaint, the trader improperly "failed to provide [the] best execution for orders placed by … institutional customers" in violation of the anti-fraud provisions of the Securities Act and Exchange Act, including Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder.[35] The SEC further alleged that two Knight supervisors aided and abetted the trader's violations by knowingly or recklessly "misstating to Knight's customers and the public that Knight provided [the] 'best execution' and by failing to disclose 'the manner in which [the trader] priced executions to customers.'"[36]

In addressing the proper mental state requirement to be applied to its aiding and abetting claim, the SEC argued that recklessness sufficed to establish a Section 20(e) violation in those cases where the aider-abettor owed a fiduciary duty to the defrauded party.[37] Judge Pisano expressly "reject[ed] the SEC's argument that recklessness may satisfy the knowledge requirement for aiding and abetting liability under Section 20(e)," and instead held that "aiding and abetting liability under Section 20(e) requires a showing of actual knowledge, irrespective of the nature of the relationship between the aider-abettor and the defrauded party."[38] Like the courts in *Fehn*, *KPMG*, *Cedric Kushner* and *Espuelas*, Judge Pisano based his interpretation on "the plain language and legislative history of Section 20(e)."[39]

Pasternak also relied in part on a January 2008 decision by Judge Gladys Kessler of the District Court for the District of Colombia in *SEC v. Johnson.*[40] In its complaint in *Johnson*, the SEC alleged that executives of two Internet companies, PurchasePro and America Online, Inc. ("AOL"), engaged in a fraudulent scheme which allowed PurchasePro to improperly recognize revenue from the integration of a third company's Internet auction services into PurchasePro's and AOL's web sites.[41] The SEC also alleged that an AOL

executive aided and abetted PurchasePro's violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, among other provisions, by assisting PurchasePro in creating false paperwork to facilitate its revenue recognition scheme.[42] Judge Kessler "conclude[d] that recently enacted statutory language [*i.e.*, the PSLRA] must supercede [sic] any pre-existing common law interpretations of the proper scienter standard" for aiding and abetting claims, and that, as a result, "the 'knowing' standard should be applied to … alleged violations of Section 20(e)."[43]

CONCLUSION

Given the clarity of the language employed by Congress in the enacted version of Section 20(e) and the straightforward legislative history of the PSLRA, the uniformity of recent decisions requiring a showing of actual knowledge in aiding and abetting cases is not surprising. What is surprising is that courts guided by such statutory language and expressions of legislative intent should ever have permitted a showing of anything less than actual knowledge to satisfy the requirements of Section 20(e) in the first place. To be sure, what appears to be an emerging consensus is not without fissures; courts are still wrestling, for example, with the proper mental state requirement for aiding and abetting claims in cases in which the underlying primary violation does not require a showing of scienter.[44] Nonetheless, the recent decisions that have taken the time to unpack the history of aiding and abetting law have properly concluded that, in codifying the SEC's right to bring aiding and abetting claims, Congress intended to settle the split in the courts over the mental state showing the SEC must make, and, specifically, to disallow aiding and abetting claims based on mere recklessness.

NOTES

2. *IIT v. Cornfeld*, 619 F.2d 909, 922 (2d Cir. 1980).

3. *Armstrong v. McAlpin*, 699 F.2d 79, 91 (2d Cir. 1983) (citations and quotations omitted); *see also Ross v. Bolton*, 904 F.2d 819, 824 (2d Cir. 1990) (applying two-step analysis).

4. *See Levine v. Diamanthuset, Inc*., 950 F.2d 1478, 1483 (9th Cir. 1991).

5. 687 F.2d 778, 791 (3d Cir. 1982).

6. 511 U.S. 164 (1994).

7. S. Rep. No. 104-98, at 4 (1995).

8. *Id*.

9. *Id*. at 19.

10. *Id*. at 7.

11. 15 U.S.C. § 78t(e) (2000).

12. *See, e.g., SEC v. Cedrick Kushner Promotions, Inc.*, 417 F. Supp. 2d 326, 334 (S.D.N.Y. 2006).

13. *SEC v. KPMG LLP*, 412 F. Supp. 2d 349, 382-83 (S.D.N.Y. 2006).

14. *Id*. at 383 (quoting *Gustafson v. Alloyd Co*., 513 U.S. 561, 570 (1995)).

15. S. Rep. No. 104-98, at 19 (1995).

16. *Id*. at 28.

17. *Id*. at 49.

18. 412 F. Supp. 2d at 383 (quoting 141 Cong. Rec. S9032, S9083 (daily ed. June 26, 1995) (statement of Sen. Bryan)).

19. 97 F.3d 1276, 1288 n.11 (9th Cir. 1996).

20. *SEC v. Peretz*, 317 F. Supp. 2d 58, 64 (D. Mass. 2004).

21. 200 F. Supp. 2d 384, 400 (S.D.N.Y. 2002).

22. *Peretz,* 317 F. Supp. 2d at 63-64.

23. No. Civ. 04-2315 (WHW), 2005 WL 1206841, at *7 (D.N.J. May 20, 2005).

24. Many aiding and abetting decisions issued after the enactment of the PSLRA that adopt a lower mental state requirement either make no reference to the PSLRA or rely on pre-PSLRA case law, or both. *See, e.g., SEC v. Snyder*, No. 07-20455, 2008 WL 4218781, at *7 (5th Cir. Sept. 16, 2008); *SEC v. Grendys*, No. 07-120 (CKK), 2008 WL 4377450, at *4 (D.D.C. Sept. 29, 2008); *SEC v. Thielbar*, No. Civ. 06-4253, 2008 WL 4360964, at *9 (D.S.D. Sept. 24, 2008); *SEC v. Power*, 525 F. Supp. 2d 415, 422 (S.D.N.Y. 2007); *SEC v. Cohen*, No. 4:05CV371-DJS, 2007 WL 1192438, at *18-19 (E.D. Mo. Apr. 19, 2007); *SEC v. Jones*, No. 05 Civ. 7044 (RCC), 2006 WL 1084276, at *7 (S.D.N.Y. Apr. 25, 2006); *SEC v. Orr*, No. 04-74702, 2006 WL 542986, at *12 (E.D. Mich. Mar. 6, 2006); *SEC v. Penthouse Int'l, Inc*., 390 F. Supp. 2d 344, 355 (S.D.N.Y. 2005). Other decisions adopting a lower standard acknowledge the language of Section 20(e) but fail to examine the legislative history of the PSLRA. *See, e.g., SEC v. Koenig*, No. 02 C 2180, 2007 WL 1074901, at *8 (N.D. Ill. Apr. 5, 2007); *SEC v. Treadway*, 430 F. Supp. 2d 293, 336-37 (S.D.N.Y. 2006). In light of the plain language and legislative history of Section 20(e), such decisions, which offer little or no historical analysis of aiding and abetting liability, are of little help in determining what mental state requirement Congress intended to codify in the PSLRA.

25. *KPMG*, 412 F. Supp. 2d at 382.

26. *Id*. at 383.

27. 417 F. Supp. 2d 326, 334-35 (S.D.N.Y. 2006).

28. *Id*. at 335.

29. *SEC v. Sandifur*, No. C05-1631C, 2006 WL 538210, at *11 (W.D. Wash. Mar. 2, 2006).

30. No. 06 Civ. 2435, 2008 WL 4414516, at *19-20 (S.D.N.Y. Sept. 30, 2008). In an August 22, 2008, decision in *SEC v. Badian*, No. 06 Civ. 2621 (LTS) (DFE), 2008 WL 3914872 (S.D.N.Y. Aug. 22, 2008), district court judge Laura Taylor Swain cited *Cedric Kushner* and *KPMG* favorably for the proposition that, as used in Section 20(e), the term "knowingly" requires "actual knowledge," and held that the complaint at issue there "allege[ed] sufficient facts to establish that [defendants] … had actual knowledge that their actions were unlawful, and that Plaintiff [had] adequately pled its [aiding and abetting] claim with scienter." *Id.* at *8. While the *Badian* opinion does not delve into the basis for that reading of Section 20(e), the court's citation to *Cedric Kushner* and *KPMG* can fairly be interpreted to have endorsed the plain-language-and-legislative-history rationale on which those decisions rest.

31. *Espuelas*, 2008 WL 4414516, at *1, 19-20.

32. *Id*. at *7-8.

33. *Id*. at *7.

34. No. 05-3905 (JAP), 2008 WL 2501355, at *37-38 (D.N.J. June 24, 2008).

35. *Id*. at *1-2.

36. *Id.* at *2.

37. *Id*. at *37.

38. *Id.* at *38.

39. *Id*.

40. 530 F. Supp. 2d 325 (D.D.C. 2008).

41. *Id*. at 326-27.

42. *Id.* at 328.

43. *Id.* at 334.

44. *See, e.g., Ponce v. SEC*, 345 F.3d 722, 737 (9th Cir. 2003) (applying recklessness standard to allegations of aiding and abetting violations of Sections 13(a) and 13(b)(2) of the Exchange Act, but noting that "there is apparently no circuit law articulating the requirements for aider and abettor liability for Section 13 violations"); *SEC v. Espuelas,* No. 06 Civ. 2435, 2008 WL 4414516, at *20 (S.D.N.Y. Sept. 30, 2008) (applying actual knowledge standard to allegations of aiding and abetting violations of Sections 13(a) and 13(b)(2)(A) of the Exchange Act); *SEC v. Intelliquis Int'l, Inc*., No. 2:02-CV-674 PGC, 2003 WL 23356426, at *12-13 (D. Utah Dec. 11, 2003) (acknowledging "knowingly" standard established by Section 20(e) but holding that Ninth and Tenth Circuits continue to apply recklessness standard for aiding and abetting violations of the reporting and books and records provisions of the securities laws).

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