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CLIENT MEMORANDUM

SECOND CIRCUIT DECISION CLARIFIES THE STANDARD FOR CLAIMS OF AIDING AND ABETTING SECURITIES FRAUD

A recent court decision by the United States Court of Appeals for the Second Circuit has made it easier for the Securities and Exchange Commission to bring claims against individuals for assisting with securities law violations. The August 8, 2012 decision in *SEC v. Apuzzo*, 11-696-CV (2d Cir. 2012), states that the SEC need not prove that an individual directly caused injuries in a securities fraud scheme in order to charge that individual as an aider and abettor to the scheme. The defendant in the case, Joseph Apuzzo, argued that although he had knowledge of a fraudulent scheme in which his company and a customer were involved, he could not be charged as an aider and abettor because his actions were not the "proximate cause" of the harm resulting from the fraudulent activity. The Second Circuit rejected Apuzzo's argument, concluding that the "proximate cause" standard used in private tort actions is too high a standard for SEC enforcement actions that seek to deter fraudulent behavior by companies and their executives.

Section 20(e) of the Securities Exchange Act of 1934 allows the SEC to bring civil actions against individuals that knowingly or recklessly provide substantial assistance to a primary violator of the securities laws. The Second Circuit's decision clears up the confusion surrounding what constitutes "substantial assistance" under Section 20(e). In addition to reviving a 2007 SEC complaint against Apuzzo, the Second Circuit's recent decision eases the SEC's pleading standard. Although stand-alone aiding and abetting cases by the SEC are rare, this lower standard enhances the SEC's ability to bring such claims.[1] However, it remains to be seen whether the lower standard will increase the number of enforcement actions against company executives and others who play a role in the violation of securities laws.

[1] Since the filing of the SEC's complaint against *Apuzzo*, the Dodd-Frank Act has expanded the SEC's enforcement power. Prior to the enactment of Dodd-Frank, the SEC could seek monetary penalties against a secondary actor only through an injunctive civil action in federal court. This meant that where the SEC sought penalties, it had to bring an action in front of a U.S. District Court judge and meet the standard for an aiding and abetting claim. However, the Dodd-Frank Act has granted the SEC the ability to seek monetary penalties against secondary actors in administrative cease-and-desist proceedings as well. Cease-and-desist orders function as the administrative counterpart to an injunction, but with a less stringent standard. Section 21C of the Securities Exchange Act of 1934 authorizes the SEC to order any person who was a cause of a violation, due to an act or omission the person knew or should have known would contribute to such violation, to cease and desist from committing or causing such violation and any future violation. For such an order, the SEC must prove that (1) a primary violation occurred; (2) there was an act or omission by the respondent that was a cause of the violation; and (3) the respondent knew, or should have known, that his conduct would contribute to the violation. *Erik W. Chan*, 55 S.E.C. 715, 724-25 (2002). Traditionally, the "causation" requirement can be met by establishing mere negligence on the part of the secondary actor. *See, e.g., KPMG Peat Marwick LLP*, 54 S.E.C. 1135, 1175 (2001). This new authority to seek monetary penalties in administrative hearings, combined with a lower standard than that traditionally used in aiding and abetting claims, gives the SEC a powerful incentive to bring more cases as administrative actions.

Background

In December 2007, the SEC accused Joseph Apuzzo, former Chief Financial Officer of construction equipment manufacturer Terex Corp., of aiding and abetting securities laws violations through his participation in a fraudulent accounting scheme involving United Rentals, Inc. ("URI"). URI is an equipment rental company and also an important customer of Terex. The SEC complaint states that Apuzzo helped URI's then-CFO, Michael Nolan, carry out two fraudulent "sale-leaseback" transactions that were structured to inflate company profits. The transactions allowed URI to prematurely recognize revenue from equipment sales to General Electric Credit Corporation ("GECC"). Under the terms of the sales transactions, URI sold a collection of used equipment to GECC, a financing company, with an accompanying agreement to lease the equipment back for a fixed period of time. In order to secure GECC's participation in these transactions, URI convinced Terex to resell the equipment on behalf of GECC after the lease period ended. Terex further agreed to provide a residual value guarantee to GECC stating that after the resale, GECC would receive no less than 96% of the price it paid for the equipment.

Under Generally Accepted Accounting Principles ("GAAP"), URI could immediately recognize the revenue from the GECC sales only if certain criteria were met. These criteria include that the "risks and rewards of ownership" had been fully transferred to GECC. Unknown to the public, URI had already agreed to indemnify Terex for any losses incurred as a result of the value guarantee to GECC. This indemnification agreement meant that URI had not yet fully transferred the risks and rewards of ownership and was, therefore, prohibited under GAAP from recording the sales revenue.

The SEC complaint alleges that Apuzzo executed various agreements that hid URI's risks and financial obligations to Terex, in addition to approving invoices that were concealing indemnification payments made to Terex. Apuzzo allegedly knew that if the indemnification payments were disclosed, URI's auditors would object to the recognition of revenue from the sale-leaseback transaction in URI's year-end financial statements. The SEC complaint alleges that in order to hide these aspects of the transaction, Apuzzo signed and approved fraudulent documents that were passed on to URI's accounting department by the CFO, Nolan.

Nolan was sentenced to three years of probation after pleading guilty to one count of making a false SEC filing. His related SEC civil case was also settled. Apuzzo moved to dismiss the SEC complaint against him, arguing that the SEC failed to adequately plead an action for aiding and abetting. In order to hold an individual liable as an aider and abettor in a civil enforcement action for securities fraud, the SEC must prove (1) the existence of a securities law violation by the primary party; (2) knowledge of this violation on the part of the aider and abettor; and (3) "substantial assistance" by the aider and abettor in the achievement of the primary violation. *SEC v. DiBella*, 587 F.3d 553, 566 (2d Cir. 2009). The United States District Court for the District of Connecticut granted Apuzzo's request, holding that the SEC failed to adequately allege "substantial assistance" by Apuzzo. *See SEC v. Apuzzo*, 758 F. Supp. 2d 136 (D. Conn. 2010). The SEC appealed to the Second Circuit Court of Appeals.

The Second Circuit Opinion

Writing for a three-judge panel, U.S. District Court Judge Jed Rakoff overturned the decision by the Connecticut district court. Judge Rakoff found that the SEC complaint *did* plausibly allege that Apuzzo aided and abetted a primary securities law violation, and therefore the case against Apuzzo could proceed.

The district court had dismissed Apuzzo's claim because it held that the "substantial assistance" prong requires a finding that the aider and abettor proximately caused the harm on which the primary violation is predicated. The district court derived this standard from private actions brought pursuant to section 10(b) of the Securities Exchange Act.[2] Conceding that the complaint contained factual allegations that, if taken as true, support a finding of "but for" causation between Apuzzo's conduct and the primary violation, the district court nonetheless held that more was required to meet the "substantial assistance" element. Specifically, Apuzzo's actions in inflating URI's financial results, while providing assistance to the scheme, did not create the fraudulent sale-leaseback structure: Nolan was the individual responsible for bringing all the respective parties to the transaction, monitoring URI's financial statements, and forwarding the fraudulent documents to URI's accounting department. As the district court explained, Apuzzo did not give Nolan, or others, authorization that was necessary for them to carry out the fraudulent scheme.

On appeal, the Second Circuit rejected the district court's strict interpretation of the "substantial assistance" element. Judge Rakoff explained that the "proximate cause" standard is appropriate only for private tort actions that seek to compensate an individual for damages he has incurred as a result of a defendant's actions. However, in the context of an enforcement action by the government, where the goal is deterrence and not compensation, proximate cause is too stringent a standard to apply. As Judge Rakoff explained, "[m]any if not most aiders and abettors would escape all liability if such a proximate cause requirement were imposed since, almost by definition, the activities of an aider and abettor are rarely the direct cause of the injury brought about by the fraud." Instead, in defining "substantial assistance," Judge Rakoff drew on a 1938 criminal case ruling by Judge Learned Hand that defines an aider and abettor as one who associates himself with the venture, participates in it as something that he wishes to bring about, and seeks to make the fraud successful through his actions. *United States v. Peoni*, 100 F.2d 401, 402 (2d Cir. 1938).

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[2] The Connecticut district court looked to the standard in *Bloor v. Carro, Spanbock, Londin, Rodman & Fass*, 754 F.2d 57 (2d Cir. 1985) as controlling. The *Bloor* case involved a private action by a fund trustee against the principal officers and controlling stockholders of the fund. The plaintiff alleged that the defendants had mismanaged and looted corporate funds, resulting in the fund's insolvency. In *Bloor*, the court ultimately held that the plaintiff failed to show the necessary causal relationship between the challenged actions and the injury to the fund. As expressed in the court's opinion, "[i]n alleging the requisite 'substantial assistance' by the aider and abettor, the complaint must allege that the acts of the aider and abettor proximately caused the harm to the corporation on which the primary liability is predicated." The court looked to a long line of private actions applying the "proximate cause" standard in reaching its decision. *See, e.g., Armstrong v. McAlpin*, 699 F.2d 79 (2d Cir. 1983); *Edwards & Hanly v. Wells Fargo Sec. Clearance Corp.*, 602 F.2d 478 (2d Cir. 1979).

Applying Judge Hand's standard, the Second Circuit concluded that the allegations in the complaint, if true, would amount to "substantial assistance" in the achievement of the securities law violation by URI. As the court explained, Apuzzo associated himself with the fraud, participated in the fraud, and sought to make the fraud a success through actions that included negotiating the details of the sales transactions, approving and signing the agreements designed to hide URI's continuing risks and financial obligations, and approving or having knowledge of the issuance of Terex's inflated invoices. The court also noted that because the SEC plausibly alleged a high degree of knowledge by Apuzzo, the SEC's burden in meeting the substantial assistance threshold is lessened. That is, given Apuzzo's detailed knowledge of the fraudulent accounting scheme by URI, his actions in preparing and approving certain financial documents and agreements can easily be viewed as efforts purposely to assist the fraud, as opposed to actions taken during the ordinary course of business.

Conclusion

The Second Circuit's *Apuzzo* decision represents a victory for the SEC. The clarification of a lower "substantial assistance" pleading standard enhances the SEC's ability to bring aiding and abetting claims against individuals who assist in carrying out a fraudulent scheme, even if their actions do not result in direct harm. Nonetheless, it remains true that stand-alone aiding and abetting claims are quite rare and a lower standard may not do much to change the frequency with which the SEC brings such actions.

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