UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Administrative Proceedings Rulings
Release No. 4937 / August 1, 2017

Administrative Proceeding
File No. 3-17950

In the Matter of

David Pruitt, CPA

Order Denying Motion for Ruling on Pleadings

Respondent David Pruitt, CPA, moves for a ruling on the pleadings. The Division of Enforcement opposes Pruitt's motion, arguing that accepting its pleadings as true, the allegations in the order instituting proceedings (OIP) are adequate as matter of law. As is discussed below, because Pruitt is not entitled to a ruling as a matter of law, his motion is denied.

1. *Motions under Rule of Practice 250(a)*

Securities and Exchange Commission Rule of Practice 250(a) permits a party to move for a ruling on the pleadings as a matter of law. 17 C.F.R. § 201.250(a). A movant who files such a motion must show that, "even accepting all of the non-movant's factual allegations as true and drawing all reasonable inferences in the non-movant's favor, the movant is entitled to a ruling as a matter of law." *Id.* This rule "is analogous to Rules 12(b)(6) and 12(c) of the Federal Rules of Civil Procedure." Amendments to the Commission's Rules of Practice, Securities Exchange Act of 1934 Release No. 78319, 81 Fed. Reg. 50,212, 50,224 n.110 (July 29, 2016).

Courts adjudicating motions under Rules 12(b)(6) and 12(c) may not consider facts outside the pleadings. *United States v. Wood*, 925 F.2d 1580, 1581 (7th Cir. 1991). Courts may, however, consider documents attached to a complaint or incorporated in it and may take notice of matters subject to judicial notice, including documents filed with the Commission. *Id.* at 1582; *see Lovelace v. Software Spectrum Inc.*, 78 F.3d 1015, 1017–18 (5th Cir. 1996); *see also* 17 C.F.R. § 201.323. "A complaint survives a motion for judgment on the pleadings if it contains sufficient factual matter, accepted as true, to state a claim to relief that is 'plausible on its face.'" 2 Moore's Federal Practice -

Civil § 12.38 (LEXIS 2017). A motion to dismiss under rule 12(c) should only be granted if the non-movant "would not be entitled to relief under any set of facts that he could prove consistent with the complaint." *Johnson v. Johnson*, 385 F.3d 503, 529 (5th Cir. 2004).

2. Facts accepted as true for purposes of this order

In the OIP, the Division made the following relevant allegations, which I accept as true for purposes of this order. *See* 17 C.F.R. § 201.250(a). Through its subsidiaries, ASD and Vertex, L3 Technologies, Inc., contracted to provide aircraft maintenance to a customer. OIP ¶ 7. Pruitt was ASD's vice president of finance. OIP ¶ 2. Pruitt learned that revenue on ASD's contract was recognized once a billing clerk generated an invoice, which, on being generated, was supposed to then be transmitted to the customer. OIP ¶ 20. After learning this information, "Pruitt … instructed a subordinate to create 69 invoices related to unresolved claims under [the customer contract] in L3's internal accounting system … and withhold delivery of those invoices from the" customer. OIP ¶ 2; *see* OIP ¶ 23.

The ASD business manager assigned to the aircraft maintenance contract was concerned about Pruitt's instruction and reported to the contract manager that he thought Pruitt was attempting to "avoid Corporate policy and … 'hide' this from the auditors." OIP ¶ 24. The contract manager then spoke to Pruitt who said that he had been instructed by "Group" to generate invoices but not deliver them. OIP ¶ 25. "By entering the invoices in" L3's internal accounting system, ASD "improperly recognized approximately $17.9 million in additional revenue." OIP ¶ 2. Because ASD recognized this additional revenue attributed to the invoices that were not delivered to the customer, ASD met a financial threshold that enabled Pruitt to receive a bonus. OIP ¶ 27; *see* OIP ¶ 9.

"[T]he vast majority of" the withheld "invoices were never submitted to the" customer and were only discovered later "during an [internal] investigation." OIP ¶¶ 2, 39. The failure to deliver the invoices to the customer represented a "violation of *a specific internal control* of L3 that required delivery of invoices." OIP ¶ 39 (emphasis added). And in accordance with applicable accounting standards and generally accepted accounting principles, L3 should not have recognized the revenue associated with the undelivered invoices. OIP ¶ 40.

L3's annual Form 10-K for the year ended December 31, 2013, was inaccurate, in part due to the improper recognition of revenue associated with the invoices. OIP ¶¶ 41–42. After an investigation, L3 later amended its 2013 annual report and a subsequent quarterly report. OIP ¶¶ 39, 42.

3. The Division's allegation under Exchange Act Section 13(b)(2)(A) states a legally cognizable claim.

The Division alleges that Pruitt caused L3 to improperly recognize $17.9 million in revenue by generating the invoices that were not submitted to L3's customer. The Division claims that through this action, Pruitt caused a violation of Section 13(b)(2)(A) of the Exchange Act, which requires issuers to "make and keep books, records, and accounts, which, *in reasonable detail*, accurately and fairly reflect the transactions and dispositions of the assets of the issuer." 15 U.S.C. § 78m(b)(2)(A) (emphasis added); OIP ¶ 43.

Relying on the phrase *in reasonable detail*, Pruitt argues that the Division's allegations fail as a matter of law. Mot. at 3–7. By way of background, paragraph (2) was added to Section 13(b) as part of the Foreign Corrupt Practices Act of 1977. *See* Pub. L. 95-213, § 102, 91 Stat 1494. The Senate bill that contained the proposed the new paragraph (2) would have required issuers to "make and keep books, records, and accounts which *accurately and fairly* reflect" the "transactions and dispositions of" the issuer's assets. S. Rep. No. 95-114, at 16 (1977) (emphasis added). Concerned that the emphasized language would require an "unrealistic" "degree of exactitude and precision," the conference committee rejected the phrase *accurately and fairly* in favor of the phrase *in reasonable detail*. H.R. Conf. Rep. 95-831, at 10 (1977). The conference committee believed the adopted language made "clear that [an] issuer's records should reflect transactions in conformity with accepted methods of recording economic events and effectively prevent off-the-books slush funds and payments of bribes." *Id*. In line with this belief, Congress defined *reasonable detail* as the "level of detail … as would satisfy prudent officials in the conduct of their own affairs." 15 U.S.C. § 78m(b)(7).

In 1981, Commission Chairman Harold M. Williams gave an address which, with the concurrence of the Commission's other members, constituted Commission policy. *See* Foreign Corrupt Practices Act of 1977, Exchange Act Release No. 17500, 1981 WL 36385, at *1 (Jan. 29, 1981). Relevant to Section 13(b)(2)(A), Chairman Williams stated that "the Act … provide[s] a *de minimis* exemption, though not in absolute, quantitative terms." *Id*. at *5.

Pruitt seizes on former Chairman Williams's recognition that Section 13(b)(2)(A) contains a *de minimis* exception. Mot. at 4–7. He argues that $17.9 million in revenue amounted to 0.14 percent of L3's total 2013 revenues, which he asserts is *de minimis*. *Id*. at 5.

If the Division had alleged in the OIP that Pruitt accidently caused L3 to recognize $17.9 million in revenue, Pruitt might have a point. If in the course

of attempting to accurately and fairly maintain its books, records, and accounts, an issuer incorrectly recognizes unrealized revenue amounting to 0.14 percent of its total annual income, the issuer could plausibly argue that its error was *de minimis* and thus not a violation of Section 13(b)(2)(A).

But the Division did not allege Pruitt unintentionally caused L3 to recognize $17.9 million in revenue; it alleges that Pruitt intended to do what he did. And the *de minimis* exemption provides a safe harbor for an issuer that "records … transactions in conformity with accepted methods of recording economic events," H.R. Conf. Rep. 95-831, at 10 (1977), not an issuer whose officers intentionally recognize revenue that they allegedly know should not be recognized. In other words, it is not a free pass to intentionally misrecognize just a little bit of revenue. Intentionally misrecognizing $17.9 in revenue is not "so insignificant that [it] may [be] overlook[ed] … in deciding an issue or case." *De Minimis*, Black's Law Dictionary (10th ed. 2014).

4. The Division's allegations under Section 13(b)(5) also state a claim.

The Division also alleged that Pruitt violated Exchange Act Section 13(b)(5), which prohibits circumventing a system of internal accounting controls. OIP ¶ 44; *see* 17 U.S.C. § 78m(b)(5); OIP ¶ 39 ("The invoices had not been delivered to the [customer], in violation of a specific internal control of L3 that required delivery of invoices."). After the Commission initiated this proceeding, Pruitt moved for a more definite statement seeking to learn which internal control the Division claimed he violated. *See David Pruitt, CPA*, Admin. Proc. Rulings Release No. 4888, 2017 SEC LEXIS 1945, at *1 (ALJ June 23, 2017). The Division responded that Pruitt violated more than one internal control and added that "among others," Pruitt violated controls IR 4, IR 5, and FR 4A. *Id.* at *2. Pruitt replied that the Division's use of the phrase *among others* left 500 internal controls in play. *Id.* In light of the ambiguity raised by the Division's opposition, I ordered the Division to provide a "list of the internal control or controls that it asserts are relevant to the alleged violation of Exchange Act Section 13(b)(5)." *Id.* at *9. The Division responded with a list of 16 internal controls. *See* Letter from Paul G. Gizzi to John J. Carney (June 30, 2017).

In moving for ruling on the pleadings, Pruitt argues that none of the 16 internal controls the Division has identified require delivery of invoices to a customer. Mot. at 7. The Division responds that the allegations in the OIP, noted above, are sufficient to plead a violation of Section 13(b)(5). Opp. at 16. As the Division sees it, I should not consider its letter specifying the relevant controls. *Id.* at 16 n.7. But even if I do consider the letter, the Division asserts that IR 4 is "the specific control that contains [the] distribution requirement."

Opp. at 3; *see id.* at 16–17. Pruitt does not discuss in his reply whether I should consider IR 4, but argues that it does not require delivery.[1] Reply at 10–11.

Aside from the Division's assertion that I should not consider its letter, the parties do not address whether or why I should consider the identified internal controls in adjudicating Pruitt's motion. Ordinarily, the pleadings and matters subject to official notice are all that may be considered in adjudicating a motion under Rule 250(a). *Cf. Wood*, 925 F.2d at 1581–82 (reciting the standard for motions under rules of civil procedure 12(b)(6) and 12(c)). But because I granted Pruitt's motion for a more definite statement, the OIP essentially incorporates the Division's response and list of relevant internal controls.

Although the Division mentions internal control FR 4A, Opp. at 17, it only discusses IR 4 and characterizes it as "the specific control that contains [the] distribution requirement."[2] Opp. at 3. Its defense of the OIP thus stands or falls on what IR 4 says. IR 4 says:

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[1] Pruitt accuses the Division of "shift[ing] its position yet again" and asserts in his reply memorandum that I should order the Division "to state once and for all the specific control it alleges was circumvented." Reply at 10. If Pruitt believes that the Division's June 30 letter is inadequate to meet the requirements of the order I issued on June 23, the proper course is to file a motion for appropriate relief, giving the Division an opportunity to respond. Requesting new relief in a reply memorandum is improper. *See Nat'l Black Chamber of Commerce v. Busby*, 795 F. Supp. 2d 1, 4 n.1 (D.D.C. 2011).

[2] The Division asserts:

> Respondent failed to discuss the specific control that contains this distribution requirement. Indeed, Invoicing and Receivable Control 4 ("IR 4") provides, in relevant part, that "[t]he Finance Department posts each invoicing transaction upon its preparation and distribution to the customer …." Respondent makes no attempt to square the plain language of IR 4 with his argument that "there was simply no control that required delivery of invoices."

Opp. at 3 (citations omitted).

> The Finance Department posts each invoicing transaction upon its preparation and distribution to the customer to a separate subsidiary ledger or general ledger account for each type of billing method used by the Financial Reporting Location, which records information about the invoice (for example, the relevant information listed above in Control No. (3)). Alternatively, batch processing of invoices may be utilized.

Mot. Ex. A at 14 of 16 PDF pages.

In his reply to the Division's opposition, Pruitt says that "IR 4 … simply does not require delivery of an invoice and only pertains to posting of the invoice. IR 4 also does not address the recognition of revenue." Reply at 10.

Neither side attempts to explain what IR 4 means. Instead, each side claims it is written in "plain language." Opp. at 3; Reply at 10. I do not find IR 4 to be plain on its face; testimony about its meaning in an accounting context or about the practice at L3 may be needed to determine whether Pruitt circumvented it. Construing its meaning in the light most favorable to the Division, however, IR 4 requires L3's finance department to *post*, *i.e.*, record in a ledger, an *invoicing transaction* at the same time the invoice for the transaction is "prepar[ed] and distribut[ed] to the customer." In other words, the recording of the transaction can only occur if the invoice is prepared and distributed to the customer. If the invoice is not distributed—and thus delivered—to the customer, then recording of the transaction cannot occur consistently with IR 4 and the internal control has been violated. Viewed in the light most favorable to the Division, IR 4 requires delivery of an invoice to a customer at the same time the invoice is generated and the transaction that is the invoice's subject is recorded.

In light of the foregoing, Pruitt's motion is denied.

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James E. Grimes
Administrative Law Judge