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UNITED STATES DISTRICT COURT  
WESTERN DISTRICT OF WASHINGTON  
AT SEATTLE

AVENTA LEARNING, INC., et al.,

Plaintiffs,

v.

K12 INC., et al.,

Defendants.

CASE NO. C10-1022JLR

ORDER DENYING  
DEFENDANTS’ MOTION TO  
DISMISS AMENDED  
COMPLAINT

**I. INTRODUCTION**

This matter is before the court on Defendants K12 Inc. (“K12”), Kayleigh Sub Two LLC (“Kayleigh”), and KC Distance Learning, Inc.’s (“KCDL”) motion to dismiss (Dkt. # 39) Plaintiffs Aventa Learning, Inc. (“Aventa”), Michael J. Axtman, James J. Benitez, Dr. Ronald P. Benitez, Elizabeth A. Benitez, Robert E. Harbison, and Susanne M. Harbison’s amended complaint (Dkt. # 26). The court has considered Defendants’ motion, Defendants’ request for judicial notice of certain items (Dkt. # 40), Plaintiffs’ responses to Defendants’ motion to dismiss and to Defendants’ request for judicial notice (Dkt. ## 43,

1 45), the declaration of Michael A. Goldfarb (Dkt. # 44), Defendants' reply (Dkt. # 46),  
2 and the declaration of Ronald Berenstein (Dkt. # 47), as well as the files and records  
3 herein. The court finds that oral argument is unnecessary for disposition of this motion.  
4 Being fully advised herein, the court DENIES Defendants' motion to dismiss (Dkt. # 39).

## 5 **II. BACKGROUND**

6 For purposes of a motion to dismiss under Federal Rule of Civil Procedure  
7 12(b)(6), the court must accept all well-pleaded facts in the complaint as true and draw all  
8 reasonable inferences in favor of the plaintiff. *Wylar Summit P'ship v. Turner Broad.*  
9 *Sys.*, 135 F.3d 658, 663 (9th Cir. 1998). Those facts, as alleged in Plaintiffs' amended  
10 complaint, are as follows.

11 Aventa is a Washington corporation founded in 2002 by two of the individual  
12 plaintiffs, Michael Axtman and James Benitez. (Am. Compl. (Dkt. # 26) ¶¶ 1, 4, 9.)  
13 Aventa assists schools in bringing their educational curricula online. (*Id.* ¶ 4.) Since its  
14 founding, Aventa has partnered with more than 1,800 school districts and other  
15 organizations around the country to bring online courses to middle and high school  
16 students in Grades 6-12. (*Id.* ¶¶ 4, 10.)

17 Pursuant to an Asset Purchase Agreement ("APA"), dated January 10, 2007, KCDL  
18 acquired substantially all of the assets of Aventa. Individual plaintiffs, Mr. Axtman, Mr.  
19 Benitez, Dr. Benitez, Ms. Benitez, Mr. Harbison, and Ms. Harbison are the sole  
20 shareholders in Aventa. (*Id.* ¶ 5.)

21 In late 2006, KCDL and Aventa engaged in discussions concerning KCDL's  
22 interest in acquiring Aventa. (*See id.* ¶ 12.) On October 26, 2006, the parties signed a

1 Letter of Intent (“LOI”) outlining the basic terms of the transaction. (*Id.* ¶ 13.) The LOI  
2 indicated that, in addition to cash and a payment tied to an earnout formula, Plaintiffs  
3 would be granted a “Phantom Equity Interest” equal in value to three percent (3%) of the  
4 outstanding equity in KCDL. (*Id.*) The LOI was amended on November 30, 2006, to  
5 reflect a revised equity figure of six percent (6%) of the assumed equity value of KCDL.  
6 (*Id.* ¶ 14.)

7 Plaintiffs asked for a calculation of KCDL’s expected earnings before interest,  
8 taxes, depreciation and amortization (“EBITDA”). (*Id.* ¶ 16.) This information was  
9 important to Plaintiffs’ evaluation of the equity portion of the transaction. (*Id.*) On or  
10 about November 30, 2006, KCDL’s former chief executive officer sent Plaintiffs various  
11 due diligence items, including the five-year model. (*Id.*) Plaintiffs allege that KCDL  
12 represented in the five-year model that EBITDA in year five would exceed \$40 million,  
13 and the five-year total would exceed \$85 million. (*Id.* ¶ 25.)

14 The parties signed the APA in January 2007. (*Id.* ¶ 17.) The opening paragraph of  
15 the APA defines itself as an agreement among KCDL, Aventa, and all of the individual  
16 plaintiffs, including Mr. Axtman, Mr. Benitez, Dr. Axtman, Ms. Benitez, Mr. Harbison,  
17 and Ms. Harbison. (*Id.* ¶ 22.) All of the individual plaintiffs are signatories to the APA.  
18 (*Id.*)

19 The APA, which was drafted by KCDL, provided for KCDL to acquire all or  
20 substantially all of Aventa’s assets in return for cash and “an earnout payment based on a  
21 formula tied to KCDL’s net revenues and EBITDA.” (*Id.* ¶¶ 17, 22.) In addition,  
22 Plaintiffs allege that the APA provided for the payment of phantom equity in the form of

1 an additional payout based on EBITDA achieved by KCDL in any given twelve month  
2 period elected by Plaintiffs (the “Additional Earnout”). (*Id.* ¶ 17.) Plaintiffs alleged that  
3 the APA, as reflected in the amended LOI, provides that the Additional Earnout is  
4 calculated based on a percentage equal to six percent (6%) of the assumed equity value of  
5 KCDL. (*Id.* ¶ 18.) Indeed, section 2.03(c)(i) states that the Additional Earnout is “equal  
6 to six percent (6%) of the Assumed Equity Value of [KCDL].” (*See* Berenstain Decl.  
7 (Dkt. # 47) Ex. 1 at § 2.03(c)(1).) The APA also provides Plaintiffs with the right, on  
8 three occasions, to require KCDL to purchase a portion of Plaintiffs’ alleged equity  
9 interest. (Am. Compl. ¶ 18.) Nowhere does the APA expressly refer to the transfer of any  
10 stock or phantom stock. (*See generally* Berenstain Decl. (Dkt. # 47) Ex. 1 (attaching  
11 executed copy of APA).) Defendants admit, however, that the APA’s Additional Earnout  
12 is based in part on “a ratio of a portion of KCDL’s . . . EBITDA . . . and revenues.” (*See*  
13 Mot. (Dkt. # 39) at 3-4 (citing APA at Ex. B & § 2.03(c)(i).) Pursuant to section 5.06 and  
14 Exhibit C of the APA, KCDL also agreed to offer employment to all of Aventa’s  
15 employees, including Mr. Axtman and Mr. Benitez. (*See id.* Ex. 1 at § 5.06 & Ex. C.)

16       Throughout the transaction, KCDL’s officers repeatedly assured Plaintiffs that the  
17 transaction would provide plaintiffs with “phantom stock” or “equity” in KCDL. (Am.  
18 Compl. ¶ 19-20.) After the transaction, Plaintiffs were referred to as “owners” of KCDL.  
19 (*Id.* ¶ 21.) Plaintiffs agreed to accept less cash upfront based on the understanding that  
20 they were making an investment in KCDL in exchange for an opportunity to receive  
21 additional profits from the equity portion of the transaction. (*Id.* ¶ 23.)  
22

1 Beginning in 2008, it became apparent that KCDL was not achieving its EBITDA  
2 targets, and it appeared that KCDL was not capitalizing certain expenses, resulting in the  
3 artificial suppression of EBITDA. (*Id.* ¶¶ 28, 30.) Plaintiffs allege that, in 2010, Mr.  
4 Axtman and Mr. Benitez learned that the five-year model was false and misleading, was  
5 not a good faith estimate, and was based on arbitrary and inflated target numbers provided  
6 by KCDL's parent company. (*Id.* ¶¶ 28, 30.)

7 Plaintiffs filed their original complaint on June 21, 2010. (Dkt. # 1.) On August  
8 30, 2010, they filed their amended complaint (Dkt. # 26), which is the subject of  
9 Defendants' present motion to dismiss. (Dkt. # 39.)

### 10 III. ANALYSIS

#### 11 A. Standards

12 When considering a motion to dismiss under Federal Rule of Civil Procedure  
13 12(b)(6), the court construes the complaint in the light most favorable to the non-moving  
14 party. *Livid Holdings Ltd. v. Salomon Smith Barney, Inc.*, 416 F.3d 940, 946 (9th Cir.  
15 2005). The court must accept all well-pleaded facts as true and draw all reasonable  
16 inferences in favor of the plaintiff. *Wylar Summit*, 135 F.3d at 661. "To survive a motion  
17 to dismiss, a complaint must contain sufficient factual matter, accepted as true, to 'state a  
18 claim to relief that is plausible on its face.'" *Ashcroft v. Iqbal*, \_\_\_ U.S. \_\_\_, 129 S. Ct.  
19 1937, 1949 (2009) (quoting *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 570 (2007)); *see*  
20 *Telesaurus VPC, LLC v. Power*, 623 F.3d 998, 1003 (9th Cir. 2010). "A claim has facial  
21 plausibility when the plaintiff pleads factual content that allows the court to draw the  
22 reasonable inference that the defendant is liable for the misconduct alleged." *Iqbal*, 129

1 S. Ct. at 1949. Dismissal under Rule 12(b)(6) can be based on the lack of a cognizable  
2 legal theory or the absence of sufficient facts alleged under a cognizable legal theory.  
3 *Balistreri v. Pacifica Police Dep't*, 901 F.2d 696, 699 (9th Cir. 1990).

#### 4 **B. Materials the Court Considers**

5 Generally, a district court may not consider any material beyond the pleadings  
6 when ruling on a Rule 12(b)(6) motion to dismiss. *Lee v. City of Los Angeles*, 250 F.3d  
7 668, 688 (9th Cir. 2001). The Ninth Circuit, however, has carved out limited exceptions  
8 to this rule. First, a court may consider material properly submitted as a part of the  
9 complaint. *Id.* Second, a court may consider documents whose contents are alleged in  
10 the complaint and whose authenticity no party questions, but which are not physically  
11 attached to the pleading. *Id.* Third, under Federal Rule of Evidence 201, a court may  
12 take judicial notice of matters of public record. *Id.* at 688-89.

13 Along with their motion to dismiss the complaint, Defendants also submitted a  
14 request that the court take judicial notice of certain documents. (Request (Dkt. # 40).)  
15 First, Defendants assert that the court may consider the APA without converting their  
16 motion to one for summary judgment. (*Id.* at 2.) Unfortunately, the copy of the APA  
17 that Defendants attached to their request for judicial notice was unsigned. (*See id.* Ex. 1.)  
18 Although Plaintiffs took “no position concerning Defendants’ request [for] judicial notice  
19 of an unsigned copy of the APA” (Resp. to Request (Dkt. # 45) at 3), Defendants  
20 nevertheless filed a signed copy of the APA along with their reply memorandum.  
21 (Berenstain Decl. (Dkt. # 47) Ex. A.) The court will consider the APA for purposes of  
22 this motion to dismiss. The APA is not appended to the amended complaint.

1 Nevertheless, Plaintiffs alleged the contents of the APA in their amended complaint and  
2 no party questions the authenticity of the document. *Lee*, 250 F.3d at 688.

3 Defendants have also requested that the court take judicial notice of two letters  
4 dated September 30, 2010. (Request Ex. B.) The first is a cover letter from Defendants'  
5 counsel to Plaintiffs' counsel concerning a notice provided under the terms of the APA.  
6 (*Id.*) The second is a letter from the General Counsel of KCDL, and the Secretary of  
7 KCDL Holdings LLC, to Aventa, Mr. Axtman, Mr. Benitz, and the law firm of Hillis  
8 Clark Martin & Perterson, P.S., purporting to provide notice under the APA of KCDL's  
9 election to pay the Additional Earnout. (*Id.*) Defendant asserts that because Plaintiffs  
10 repeatedly refer to the Additional Earnout in the Amended Complaint, the court may take  
11 judicial notice of these letters. (*Id.* at 3.) While the Amended Complaint does refer to the  
12 Additional Earnout, nowhere does the Amended Complaint refer to or rely upon these  
13 two letters, nor could it. As Plaintiffs correctly note, these letters were actually written  
14 after this lawsuit was initiated. (*See* Notice of Removal (Dkt. # 1).) Thus, it would not  
15 be appropriate for the court to consider these letters in the context of a motion to dismiss.  
16 *See, e.g., United States v. Ritchie*, 342 F.3d 903, 908 (9th Cir. 2003) (finding judicial  
17 notice appropriate "if the plaintiff refers extensively to the document or the document  
18 forms the basis of the plaintiff's claim"). Accordingly, the court denies Defendants'  
19 request for judicial notice of the September 30, 2010 letters.

20 Defendants also seek to have the court take judicial notice of several letters from  
21 the Division of Corporation Finance of the Security and Exchange Commission ("SEC")  
22 which recommend no enforcement action to the SEC in various matters. (Request Exs.

1 C-H (“no-action letters”).) The court declines to take judicial notice of the SEC no-action  
2 letters. *See, e.g., In re LDK Solar Sec. Litig.*, 584 F. Supp. 2d 1230, 1240 (N.D. Cal.  
3 2008) (no-action letter “is not a proper subject of judicial notice”).

4 Even if the court were to take judicial notice of these letters, they could not be  
5 used for the purpose Defendants urge. Citing *Cellular Eng’g, Ltd. v. O’Neill*, 820 P.2d  
6 941, 950-51 (Wash. 1991) for the proposition that the Washington Supreme Court affords  
7 “substantial weight” to the SEC’s position in deciding whether an agreement is a security  
8 under the Washington State Securities Act (“WSSA”), RCW ch. 21.20, Defendants assert  
9 that the no-action letters support the conclusion that “[t]he SEC has repeatedly taken the  
10 position that asset transactions with earnout provisions are not securities.” (Mot. at 15;  
11 *see also* Reply at 3.) Even if the no-action letters were properly admitted, the court could  
12 not rely on these letters for the purpose of drawing this conclusion. At most, the court  
13 could only take judicial notice of these letters for the limited purpose of acknowledging  
14 that the Division of Corporation Finance’s investigation of the particular matters at issue  
15 in each letter was terminated without recommendation to the SEC of any enforcement  
16 action. *See, e.g., In re Intelligroup Sec. Litig.*, 527 F. Supp. 2d 262, 274 & n.2 (D.N.J.  
17 2007).

18 The no-action letters are not pronouncements from the SEC itself, but rather  
19 statements from the Division of Corporation Finance of the SEC that the “Division will  
20 not recommend any enforcement action to the Commission.” (*See* Request Exs. D-H at  
21 1; *see also id.* Ex. C (which states that the “Division will not recommend enforcement  
22 action to the Commission”). Moreover, each of the no-action letters includes a statement

1 similar to the following, which narrowly tailors the applicability of the letter exclusively  
2 to the particular facts at hand:

3 Because this position is based on the representations made in your letter [to  
4 the Division of Corporate Finance of the SEC], it should be noted that any  
5 different facts or conditions might require a different conclusion. Further,  
6 this response only represents the Division's position on enforcement action  
7 and does not purport to express any legal conclusion on the question  
8 presented.

9 (*Id.* Ex. E at 1; *see id.* Exs. C-D at 1 & F-H at 1 (providing substantively similar  
10 statements).) Thus, even if the court were to take judicial notice of the no-action letters,  
11 they cannot be employed for the purposes Defendants propose. Accordingly, the court  
12 declines to consider these letters in the context of this motion to dismiss.

### 13 **C. Standing of Individual Plaintiffs**

14 Defendants assert that all of the individual Plaintiffs (Mr. Axtman, Mr. Benitez, Dr.  
15 Benitez, Ms. Benitez, Mr. Harbison, and Ms. Harbison) should be dismissed because it  
16 was "Aventa – not the individual [P]laintiffs – [who] sold its assets to KCDL, and in  
17 exchange . . . received consideration, including the Additional Earnout." (Mot. at 7.) In  
18 essence, Defendants assert that even if the Additional Earnout could be considered a  
19 security, the individual Plaintiffs lack standing to sue because they have no contractual  
20 rights to distribution of the Additional Earnout.

21 Neither party has cited to any case authority. (*See* Mot. at 6-7; Resp. (Dkt. # 43) at  
22 2-3.) The Supreme Court has held that a plaintiff has standing to bring a securities action  
only if he or she was an actual purchaser or seller of securities. *See Blue Chip Stamps v.*  
*Manor Drug Stores*, 421 U.S. 723, 730-31 (1975). However, an individual cause of action

1 can be asserted when the wrong is both to the stockholder as an individual, as well as to  
2 the corporation. *See Far West Fed. Bank v. Office of Thrift Supervision-Direct-OR*, 119  
3 F.3d 1358, 1363-64 (9th Cir. 1997).

4 Here, Plaintiffs have alleged that “KCDL assured [P]laintiffs that the transaction  
5 included an equity portion consistent with the parties’ intent and understanding[,] [a]nd  
6 KCDL represented that the transaction achieved [P]laintiffs’ objective to invest in  
7 KCDL.” (Am. Compl. ¶ 22.) In addition, Plaintiffs aver that:

8 Plaintiffs believed the transaction to be a cash and stock deal, and  
9 [P]laintiffs understood that they were receiving equity, in the form of  
10 “phantom stock,” in KCDL. Plaintiffs negotiated for, and were granted the  
11 right as reflected in the APA, to sell their phantom stock on three occasions.  
12 And [P]laintiffs’ [sic] ultimately agreed to accept less cash upfront than  
13 what they valued Aventa to be worth, with the understanding that they were  
14 making an investment in KCDL in exchange for the opportunity to receive  
15 additional profits from the equity portion of the transaction.

16 (*Id.* ¶ 23.) Thus, Plaintiffs have alleged a wrong to both the individual Plaintiffs with  
17 regard to the alleged equity portion of the transaction, as well as to Aventa.

18 In addition, the opening paragraph of the APA defines the agreement as among  
19 KCDL, Aventa, and the individual Plaintiffs. (*Id.* ¶ 22; APA at 1.) Individual Plaintiffs  
20 Mr. Axtman and Mr. Benitez are also defined with Aventa as “Seller Parties.” (APA at 1.)  
21 Finally, all of the individual Plaintiffs are signatories of the APA. (*See* APA; Am. Compl.  
22 at ¶ 22.) Given the foregoing allegations, and recitals in the APA, the court finds that the  
individual Plaintiffs have adequately pleaded standing to pursue their securities claim.

While this may be an issue that will present itself again at the summary judgment stage of  
this litigation, the court is unwilling to dismiss the individual Plaintiffs in the context of

1 the present Rule 12(b)(6) motion. For the same reasons, the court also denies Defendants’  
 2 motion to dismiss the individual Plaintiffs’ claims for misrepresentation, breach of the  
 3 duty of good faith and fair dealing, and for declaratory judgment.

4 **D. Plaintiffs’ WSSA Claim.**

5 Plaintiffs allege that Defendants violated WSSA, RCW 21.20, *et seq.* (Am.  
 6 Compl. ¶¶ 43-50.) There are two essential elements to a WSSA claim: “(1) a fraudulent  
 7 or deceitful act committed (2) in ‘connection with the offer, sale or purchase of any  
 8 security.’” *Kinney v. Cook*, 154 P.3d 206, 209-10 (Wash. 2007) (quoting RCW  
 9 21.20.010).<sup>1</sup> It is the second prong of this test that is at the heart of the present dispute.  
 10 Defendants contend that the amended complaint does not plead “the offer, sale or  
 11 purchase of any security,” and thus, cannot satisfy the second prong. (Mot. at 7-8; Reply  
 12 at 2.) Defendants contend that neither the APA, nor its Additional Earnout provision,  
 13 constitutes a “security” under WSSA. (Mot. at 8.)

14 The WSSA broadly defines a “security,” in pertinent part, as follows:

15 \_\_\_\_\_  
 16 <sup>1</sup>It is unlawful for any person, in connection with the offer, sale or purchase of any security,  
 17 directly or indirectly:

- 18 (1) To employ any device, scheme, or artifice to defraud;  
 19 (2) To make any untrue statement of a material fact or to omit to state a material  
 20 fact necessary in order to make the statements made, in the light of the  
 21 circumstances under which they are made, not misleading; or  
 (3) To engage in any act, practice, or course of business which operates or would  
 operate as a fraud or deceit upon any person.

22 RCW 21.20.010.  
 RCW 21.20.010.

1 “Security” means any . . . stock; . . . investment contract; investment of  
2 money or other consideration in the risk capital of a venture with the  
3 expectation of some valuable benefit to the investor where the investor does  
4 not receive the right to exercise practical and actual control over the  
5 managerial decisions of the venture; . . . or, in general, any interest or  
6 instrument commonly known as a “security” . . .

7 RCW 21.20.005(12)(a). “[T]he definition of security ‘embodies a flexible rather than a  
8 static principle, one that is capable of adaptation to meet the countless and variable  
9 schemes devised by those who seek the use of the money of others on the promise of  
10 profits.’” *Cellular Eng’g*, 820 P.2d at 946 (quoting *SEC v. W.J. Howey*, 328 U.S. 293,  
11 299 (1946)). In determining whether a transaction constitutes the sale of a security,  
12 substance prevails over form, consistent with the purpose of the act to protect the  
13 investing public. *Id.* Further, “[a]ny security given or delivered with . . . any purchase of  
14 . . . any other thing is considered to constitute part of the subject of the purchase and to  
15 have been offered and sold for value.” RCW 21.20.005(10).

16 Defendants assert that the issue of whether the Additional Earnout is a security  
17 should be analyzed under the test for an “investment contract” as stated in *Howey*, 328  
18 U.S. at 301. (Mot. at 9.) Washington courts apply a modified *Howey* test which defines  
19 an “investment contract” security as “(1) an investment of money (2) in a common  
20 enterprise and (3) the efforts of the promoter or a third party must have been  
21 fundamentally significant ones that affected the investment’s success or failure.” *Ito Int’l*  
22 *Corp. v. Prescott, Inc.*, 921 P.2d 566, 571-72 (Wash. Ct. App. 1996); *see also Cellular*  
*Eng’g*, 820 P.2d at 946.

1 In *International Brotherhood of Teamsters v. Daniel*, 439 U.S. 551 (1979), the  
2 Supreme Court clarified that the first prong of the *Howey* test, an investment of money,  
3 does not mean that a person’s investment “must take the form of cash only, rather than of  
4 goods and services.” *Id.* at 560 n.2. Further, the Ninth Circuit has also held that ““an  
5 investment of money’ means only that the investor must commit his assets to the  
6 enterprise in such a manner as to subject himself to financial loss.” *Hector v. Wiens*, 533  
7 F.2d 429, 432 (9th Cir. 1976).

8 Plaintiffs have alleged that in exchange for Aventa, they were to receive both cash,  
9 and phantom equity in KCDL. (Am. Compl. ¶¶ 13-14.) Plaintiffs further allege that  
10 under the APA KCDL acquired all (or substantially all) of the assets of Aventa in return  
11 for cash, an earnout payment based on a formula tied to KDCL’s net revenues and  
12 EBIDTA, and phantom equity in the form of the “Additional Earnout” which is calculated  
13 based on a percentage equal to six percent (6%) of the Assumed Equity Value of KCDL.  
14 (*Id.* ¶¶ 17-18.) Plaintiffs also allege that they agreed to accept less cash upfront than what  
15 they believed Aventa was worth, based on the understanding that they were making an  
16 investment in KCDL in exchange for the opportunity to receive additional profits from the  
17 equity portion of the transaction. (*Id.* ¶ 23.) Based on the standards applicable to a Rule  
18 12(b)(6) motion, Plaintiffs have adequately alleged facts representing “an investment of  
19 money” in KCDL even though that investment was in the form of Aventa’s assets and not  
20 cash, and thus have satisfied the first element of the modified *Howey* test.

21 Defendants assert that Plaintiffs fail to allege sufficient facts with regard to the  
22 second *Howey* prong – “common enterprise” – because they do not allege an

1 “interdependence of fortunes, a dependence by one party for his profit on the success of  
2 some other party in performing his part of the venture.” *See McClellan v. Sundholm*, 574  
3 P.2d 371, 374 (Wash. 1978). Defendants assert that the Additional Earnout is based, not  
4 only on a percentage of KCDL’s Assumed Equity Value, but also on the length of time  
5 that Mr. Axtman and Mr. Benitez remain employed by KCDL. (Mot. at 11.) Defendants  
6 also assert that the Additional Earnout carves out revenues attributable to other KCDL  
7 acquisitions or investments made after December 31, 2009 (APA §2.03(c)(i)), thus  
8 focusing the Additional Earnout payment on the impact of Aventa’s assets, “and the  
9 successful incorporation of those assets into KCDL’s business as facilitated by individual  
10 [P]laintiffs, [Mr.] Axtman and [Mr.] Benitez.” (Mot. at 11.) As a result, Defendants  
11 assert that “the Additional Earnout is not based solely on KCDL’s profits or earnings,”  
12 and the “common enterprise” element is not met (*Id.*)

13 Plaintiffs counter that Defendants ignore the Washington Supreme Court’s rejection  
14 of the notion that profits must come “solely” from the efforts of others: “In order to  
15 promote the remedial purpose of [WSSA], we do not require that the profits come ‘solely’  
16 from the efforts of others, as the United States Supreme Court opinion in . . . *Howey* . . .  
17 appears to indicate.” *State v. Philips*, 741 P.2d 24, 30 (Wash. 1987). Thus, Plaintiffs  
18 assert that the fact that a portion of the Additional Earnout is not based on KCDL’s profits  
19 or earnings is not fatal to their claim. (Resp. at 16.)

20 “[B]oth the Ninth Circuit and the Washington Supreme Court have established  
21 vertical commonality as the test for common enterprise.” *Winkler v. Trico Fin. Corp.*, 693  
22 F. Supp. 896, 898-99 (W.D. Wash. 1987) (citing *United States v. Jones*, 712 F.2d 1316,

1 1321 (9th Cir. 1983); *McClellan*, 574 P.2d at 374). “Vertical commonality may be  
2 established by showing ‘that the fortunes of the investors are linked with those of the  
3 promoters.’” *SEC v. R.G. Reynolds Enters., Inc.*, 952 F.2d 1125, 1130 (9th Cir. 1991)  
4 (quoting *SEC v. Goldfield Deep Mines Co. of Nevada*, 758 F.2d 459, 463 (9th Cir. 1985)).  
5 “One indicator of vertical commonality, though by no means the only indicator, is an  
6 arrangement to share profits on a percentage basis between the investor and the seller or  
7 promoter.” *Reynolds*, 952 F.2d at 1130.

8 Here, Plaintiffs have alleged that their fortunes are intertwined with KCDL’s  
9 success or failure. “[T]he APA provides that the Additional Earnout is calculated based  
10 on a percentage, ‘equal to six percent (6%) of the Assumed Equity Value’ of KCDL.”  
11 (Am. Compl. ¶ 18 (quoting APA §2.03(c)).) “Assumed Equity Value” is in turn based on  
12 KCDL’s EBITDA, which depends on KCDL’s performance. (*See* Am. Compl. ¶ 27; APA  
13 § 2.03(c).) The issues that concern Defendants including (1) the “carve out” of revenues  
14 from the Additional Earnout attributable to other KCDL acquisitions or investments made  
15 after December 31, 2009, and (2) the amount of time spent by and the level of control  
16 allowed to Mr. Axtman and Mr. Benitez with regard to the integration of Aventa’s assets  
17 into KCDL (*see* Mot. at 11), largely raise questions of fact that cannot be resolved in the  
18 context of this Rule 12(b)(6) motion. Thus, Plaintiffs have adequately alleged that their  
19 own earnings on their investment were contingent on KCDL’s performance. “This is  
20 sufficient to show vertical commonality and satisfy the second prong of *Howey*.” *R.G.*  
21 *Reynolds Enters.*, 952 F.2d at 1131.  
22

1 Plaintiffs have also adequately alleged the third element of the modified *Howey* test  
2 for purposes of this motion to dismiss. The third prong requires that the purchaser of the  
3 security have “an expectation of profits from the efforts of another.” *Suave v. K.C., Inc.*,  
4 591 P.2d 1207, 1209 (Wash. 1979). However, Defendants admit that the efforts of the  
5 promoter need only be “undeniably significant” – not total (*see* Mot. at 12 (quoting  
6 *Cellular*, 820 P.2d at 949)), and that Washington courts tolerate “some degree of  
7 involvement on the part of the investor.” (Reply (Dkt. # 46) at 7 (quoting *Cellular*, 820  
8 P.2d at 950).) *See also Christgard, Inc. v. Christensen*, 627 P.2d 136, 141 (Wash. Ct.  
9 App. 1981) (“We are satisfied that, under Washington law, an investor need not expect  
10 profits ‘solely’ from the efforts of a promoter or third party, so long as the other’s efforts  
11 are ‘the undeniably significant ones, those essential managerial efforts which affect the  
12 failure or success of the enterprise.’”) (quoting *McClellan*, 574 P.2d at 374). Plaintiffs  
13 have alleged that they expected profits from KCDL’s performance. (Am. Comp. at ¶¶ 19-  
14 23.) Further, Plaintiffs “were to receive equity in KCDL, the value of which was based on  
15 KCDL’s EBIDTA.” (*Id.* ¶ 27.) Plaintiffs also alleged that “the parties intended and  
16 understood that [P]laintiffs received equity in KCDL, and that [P]laintiffs’ potential  
17 profits or losses from their equity interest was [sic] tied to KCDL’s successes or failures.”  
18 (*Id.* ¶ 44.) Defendants assert that the contributions of Mr. Axtman and Mr. Benitez were  
19 sufficiently significant for the court to conclude that this was not the type of “passive  
20 investment” that falls within the ambit of a security. (Reply at 7.) However, once again,  
21 while this may be a determination appropriate for summary judgment, it is not appropriate  
22

1 at the pleading stage of this litigation. Plaintiffs' allegations of a claim under WSSA are  
2 sufficient to withstand dismissal on a Rule 12(b)(6) motion.

3 Plaintiffs also assert that, in addition to an investment contract, the allegations in  
4 their Amended Complaint concerning the transaction with Defendants and the Additional  
5 Earnout fall within the "risk capital" definition of a security. (Resp. at 9-11.) The  
6 Washington Legislature added "risk capital" to the definition of a security in response to  
7 the Washington Supreme Court's opinion in *Suave v. K.C., Inc.*, 591 P.2d 1207, 1209  
8 (Wash. 1979), which held the "risk capital" definition not to be the rule in Washington.  
9 *See Aspelund v. Olerich*, 784 P.2d 179, 182 (Wash. Ct. App. 1990) ("The purpose of the  
10 1979 amendment was to establish the risk capital definition of security as a part of the  
11 Washington law in light of the Washington Supreme Court's opinion in *Suave*. . . .").  
12 Specifically, RCW 21.20.005(12)(a) includes within the definition of security an  
13 "investment of money or other consideration in the *risk capital* of a venture with the  
14 expectation of some valuable benefit to the investor where the investor does not receive  
15 the right to exercise practical and actual control over the managerial decisions of the  
16 venture." *Id.* (italics added).

17 Some courts have indicated that the *Howey* test for an investment contract is "more  
18 stringent" than the risk capital definition. *See, e.g., State v. Markham*, 697 P.2d 263, 269  
19 n.6 (Wash. Ct. App. 1985). Indeed, in rejecting risk capital as applicable to the definition  
20 of a security (prior to the Legislature's amendment of RCW 21.20.005(12)(a)), the  
21 Washington Supreme Court described the risk capital approach as "requir[ing] only that  
22 risk capital be supplied with a reasonable expectation of a valuable benefit but without the

1 right to control the enterprise.” *Suave*, 591 P.2d at 1209. Other courts in Washington,  
2 while recognizing that “the risk capital definition is distinct from the definition of an  
3 investment contract,” nevertheless “appear to combine their analyses of both concepts  
4 under the *Howey* definition.” *Ultimate Timing, LLC v. Simms*, No. C08-1632-MJP, 2010  
5 WL 2650705, at \*2 (W.D. Wash. June 29, 2010) (citing *Ito Int’l*, 921 P.2d at 571). One  
6 court has declared: “Adoption of the ‘risk capital’ approach . . . does not obviate the  
7 *Howey* test that has heretofore been applied by the Washington courts.” *State v. Phillips*,  
8 725 P.2d 627, 630 (Wash. Ct. App. 1986). Thus, while the *Howey* test defines a security  
9 in the form of an investment contract, it is unclear how *Howey* applies in Washington in  
10 the context of an alleged “risk capital” security. Nevertheless, because the court finds that  
11 Plaintiffs’ allegations meet the standards required under a Rule 12(b)(6) motion when  
12 applying the *Howey* analysis, the court need not decide if those standards are also met  
13 utilizing the “risk capital” definition.

#### 14 **E. Compliance with Federal Rule of Civil Procedure 9(b).**

15 Defendants assert that Plaintiffs’ causes of action for violation of WSSA, for  
16 common law misrepresentation, and for breach of good faith fail to meet the pleading  
17 standards set forth in Federal Rule of Civil Procedure 9(b) that allegations of fraud “must  
18 state with particularity the circumstances constituting fraud or mistake.” Fed. R. Civ. P.  
19 9(b). Fraud claims and claims that “sound in fraud” or are “grounded in fraud” must  
20 satisfy the heightened pleading standards of Federal Rule of Civil Procedure 9(b). *See*  
21 *Kearns v. Ford Motor Co.*, 567 F.3d 1120, 1125 (9th Cir. 2009). This means that the  
22 amended complaint must allege “the who, what, when, where, and how” of the alleged

1 fraudulent conduct. *Id.* at 1126. While there is no absolute requirement that the complaint  
2 identify false statements made by each and every defendant in connection with an alleged  
3 fraudulent scheme, the plaintiff must at a minimum identify the role of each defendant in  
4 the alleged fraudulent scheme. *Swartz v. KPMG, LLP*, 476 F.3d 756, 764-65 (9th Cir.  
5 2007). The purpose of Rule 9(b) is to ensure that defendants accused of fraudulent  
6 conduct have adequate notice of the allegations so that they might defend against them.  
7 *Concha v. London*, 62 F.3d 1493, 1502 (9th Cir. 1995).

8 Here, Plaintiffs have properly alleged the “who” and “what” of the alleged  
9 fraudulent conduct. The “who” includes KCDL and its “officers, directors, and  
10 controlling persons,” including “KCDL’s former CEO.” (*See* Am. Compl. ¶¶16, 20, 26.)  
11 The “what,” among other things, is the 5-year model that KCDL provided to Plaintiffs that  
12 was allegedly “represented . . . to be a good faith calculation of KCDL’s expected  
13 EBITDA . . . and . . . the result of a diligent review of KCDL’s performance and future  
14 prospects.” (*Id.* ¶ 24.) Plaintiffs further allege that “KCDL failed to disclose that the 5  
15 year model was not based on actual business projections, real calculations, or genuine  
16 models,” that it was “false and misleading,” and that it did “not . . . reflect accurate  
17 calculations [or] . . . real business forecasts . . .” (*Id.* ¶¶ 25, 32, 34.)

18 Plaintiffs have also adequately pleaded the “when,” “where,” and “how” of the  
19 alleged fraudulent conduct. They allege that KCDL provided the 5-year model to them in  
20 November 2006, and that misrepresentations based in part on this 5-year model continued  
21 “[t]hroughout the negotiations and due diligence process in October and November 2006.”  
22 (*Am. Compl.* ¶¶ 24, 26.) Plaintiffs further allege that they learned for the first time in

1 2010 that the 5-year model upon which they had relied in making their decision to execute  
2 the APA was false and misleading. (*Id.* ¶ 32.) Specifically, they allege that they “learned  
3 that the 5 year model was not a good faith estimate of KCDL’s EBITDA projections and  
4 was, instead, based on arbitrary and inflated target numbers provided by KCDL’s parent  
5 company, Knowledge Learning, and did not reflect what KCDL’s management believed  
6 to be reasonable estimates of future EBITDA.” (*Id.* ¶ 33.) They have also alleged that  
7 their claims against the other two defendants, K12 and Kayleigh, are based on their  
8 assumption of, or their role as assignee of, KCDL’s liabilities. (*Id.* ¶ 47.) Thus, Plaintiffs  
9 have satisfied both the technical requirements of Rule 9(b) – that the averments of fraud  
10 be stated with particularity, as well as the purpose of Rule 9(b) – that defendants accused  
11 of fraudulent conduct have adequate notice so that they might defend themselves. *See*  
12 *Concha*, 62 F.3d at 1502. The court, therefore, denies Defendants’ motion to dismiss  
13 certain claims based on Federal Rule of Civil Procedure 9(b).

14 **F. Plaintiffs’ Claim for Breach of the Implied Covenant of Good Faith and Fair**  
15 **Dealing**

16 Washington courts recognize that every contract imposes upon the parties a duty of  
17 good faith and fair dealing in their performance and enforcement of the contract. *See, e.g.,*  
18 *Frank Coluccio Const. Co. v. King County*, 150 P.3d 1147, 1154 (Wash. Ct. App. 2007)  
19 (“There is an implied duty of good faith and fair dealing in every contract.”). The goal is  
20 to ensure that each of the parties to the contract obtains the full benefit of performance.  
21 *See id.* (citing *Metro. Park Dist. v. Griffith*, 723 P.2d 1093, 1100 (Wash. 1986)).  
22

1 | However, the implied duty arises only in connection with the terms of agreed to by the  
2 | parties. *Badgett v. Security State Bank*, 807 P.2d 356, 360 (Wash. 1991).

3 |         Plaintiffs allege that following execution of the APA KCDL shifted its focus from  
4 | EBIDTA generation and also began to use accounting practices that would artificially  
5 | suppress EBITDA. (Am. Compl. ¶¶ 35, 63-64.) Defendants assert that these practices do  
6 | not constitute violations of the covenant of good faith “because neither relates to a specific  
7 | contract term.” (Mot. at 21.) However, as Plaintiffs correctly note, the APA specifically  
8 | provides that the Additional Earnout is calculated based on a percentage “equal to six  
9 | percent (6%) of the Assumed Equity Value” of KCDL, and the Assumed Equity Value is  
10 | in turn based on KCDL’s EBITDA, both of which are specific contract terms. (*See Resp.*  
11 | *at 23; APA § 2.03(c)(i).*)

12 |         Further, Washington courts have held that in some contexts “the duty to disclose  
13 | relevant information to a contractual party [during negotiation] can arise as a result of the  
14 | transaction itself within the parties’ general obligation to deal in good faith.” *Liebergesell*  
15 | *v. Evans*, 613 P.2d 1170, 1177 (Wash. 1980). Thus, the court cannot conclude on the  
16 | basis of this Rule 12(b)(6) motion that Defendants’ alleged failure to inform Plaintiffs of  
17 | anticipated shifts away from EBIDTA generation or toward accounting practices that  
18 | would artificially suppress EBITDA would not violate Defendants’ duty of good faith.  
19 | (*See Am. Compl. ¶ 26.*) In the court’s view, Plaintiffs have adequately plead this cause of  
20 | action. Accordingly, the court denies Defendants’ motion to dismiss this cause of action.

### 1 **G. Plaintiffs' Claims for Declaratory and Equitable Relief**

2 The court denies Defendants' motion to dismiss Plaintiffs' claims for declaratory  
3 and equitable relief. Defendants assert that Plaintiffs' claim for declaratory relief and  
4 reasonable access to information concerning KCDL's EBITDA is moot based on  
5 correspondence KCDL issued on September 30, 2010, following the initiation of this  
6 lawsuit, in which KCDL allegedly invoked its right to pay the Additional Earnout. (Mot.  
7 at 22.) The court has already held that consideration of this correspondence is not  
8 appropriate in the context of a Federal Rule of Civil Procedure 12(b)(6) motion. (*See*  
9 *supra* § III.B.) Accordingly, the court denies Defendants' motion to dismiss Plaintiffs'  
10 claims for declaratory relief on this ground.

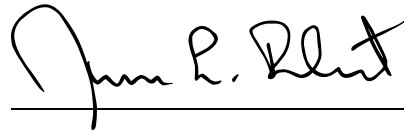
11 Defendants also assert that Plaintiffs' claim for constructive trust must be dismissed  
12 because, according to Defendants, the imposition of a constructive trust is an equitable  
13 remedy and not a separate cause of action under Washington law, and in any event the  
14 claim is not adequately pleaded under Federal Rule of Civil Procedure 8(a)(2). (Mot. at  
15 23.) However, this court has found authority for the notion that a claim for imposition of  
16 a constructive trust stands as an independent cause of action in Washington, and not just  
17 an equitable remedy. For example, although the court in *Goodman v. Goodman*, 907 P.2d  
18 290 (Wash. 1995) describes a constructive trust as "an equitable remedy," *id.* at 293, the  
19 court also states that "[a]n action based on . . . constructive trust . . . is subject to the three-  
20 year statute of limitations contained in RCW 4.16.080." *Goodman*, 907 P.2d at 294.  
21 Further, in *Bryant v. Joseph Tree, Inc.*, 791 P.2d 537 (Wash. Ct. App. 1980), the court  
22 held that an equitable claim in constructive trust had merit based on existing Washington

1 law or a good faith argument for extending existing law. *Id.* at 544. Further, the court  
2 finds that Plaintiff's claim for constructive trust is adequately pleaded, and therefore  
3 denies Defendants' motion to dismiss.

4 **IV. CONCLUSION**

5 Based on the foregoing, the court DENIES Defendants' motion to dismiss  
6 Plaintiffs' amended complaint (Dkt. # 39).

7 Dated this 27th day of March, 2011.

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10 JAMES L. ROBART  
11 United States District Judge  
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