

JUDGE SCHEINDLIN

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7944

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

SECURITIES AND EXCHANGE COMMISSION :

Plaintiff,

v.

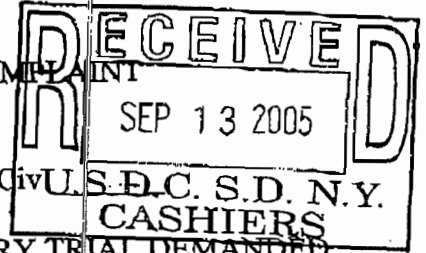
MARTIN E. KENNEY JR.

Defendant.

COMPLAINT

05 Civ

JURY TRIAL DEMANDED



Plaintiff Securities and Exchange Commission ("Commission") alleges as follows:

PRELIMINARY STATEMENT

1. During 2002, Martin E. Kenney, the Chief Executive Officer of WRC Media Inc., orchestrated the fraudulent recognition of \$1.2 million in revenue from a purported sale of educational software to the Monroe City, Louisiana School District. Kenney did so because WRC needed to generate millions of dollars in fourth quarter revenue to avoid defaulting on debt covenants and to meet revenue expectations. To facilitate the fraud, Kenney procured an unauthorized sales contract from the superintendent of the Monroe City School District that was contingent upon approval by the entire school board. The superintendent lacked contracting authority, and the contract failed to reflect the school board contingency. Kenney concealed the contingency from WRC's internal accountants and independent auditors to ensure that they would not reject fourth quarter revenue recognition. As a result, WRC filed financial reports with the Commission, certified by Kenney, that

materially misstated its fourth quarter results.

2. Kenney was involved extensively in the Monroe negotiations. In October 2002, he traveled to Louisiana, along with the sales representatives from WRC's subsidiary CompassLearning, Inc., to meet with the superintendent and help close the sale. The superintendent, however, would only agree to sign a contract that was explicitly conditioned upon school board approval. Thus, the superintendent signed a standard-form Compass contract with "pending board approval" inserted into the agreement.

3. Thereafter, Kenney learned that revenue could not be recorded under generally accepted accounting principles (GAAP) until the contingency was met. Because the Monroe sale was the largest potential deal in the company's pipeline and because WRC was at great risk of defaulting on its debt covenants, obtaining board approval by December 31, 2002 became a priority for Kenney.

4. In December 2002, Kenney learned that the school board would not vote on the potential transaction until 2003, making revenue recognition in 2002 inappropriate under GAAP. Despite knowing that Compass could not legitimately record the Monroe revenue in 2002, Kenney traveled back to Louisiana to have the superintendent sign a contract that fraudulently omitted the contingency. The non-standard replacement contract further omitted Compass' customary authority provision requiring the superintendent to represent that he was "authorized to sign on behalf" of the school board and that "all requirements necessary to authorize the execution" of the agreement had been satisfied. Nevertheless, the superintendent verbally reiterated to Kenney and the Compass salespersons that the proposed transaction was still contingent upon the approval of the entire school board. After obtaining the superintendent's signature, Kenney had the replacement contract forwarded to Compass'

internal accountants to have the revenue recorded in the fourth quarter of 2002. Kenney never told WRC's internal accountants or independent auditors about the contingency.

5. Consequently, Kenney directly or indirectly, singly or in concert, has engaged, and may be continuing to engage, in acts, practices and courses of business that constitute violations of Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") [15 U.S.C. § 78j(b)] and Rule 10b-5 promulgated thereunder [17 C.F.R. 240.10b-5].

6. By this action, the Commission seeks (i) permanent injunctive relief, (ii) civil penalties, (iii) an officer and director bar, and (iv) such further relief as the Court may deem appropriate.

JURISDICTION

7. This Court has jurisdiction over this action pursuant to Sections 21(d) and 27 of the Exchange Act [15 U.S.C. §§ 78u(d) and 78aa].

8. Defendant Kenney, directly or indirectly, has made use of the means and instrumentalities of interstate commerce, or of the mails, or of the facilities of a national securities exchange in connection with the acts, practices, and courses of business alleged herein.

9. Venue is proper in this District pursuant to Section 27 of the Exchange Act. Kenney engaged in certain transactions, acts, practices and courses of business alleged herein, including filing and furnishing periodic reports with the Commission, within this District.

DEFENDANT

10. Martin E. Kenney, Jr., age 57, resides in Paoli, Pennsylvania, and was Chief Executive Officer and a director of WRC Media, Inc. Kenney was also the Chief Executive Officer of CompassLearning, Inc., a wholly owned subsidiary of WRC. During all relevant times, Kenney was a principal spokesperson for WRC responsible for communicating the company's financial results to investors. He signed WRC's periodic reports on Forms 10-K and 10-Q and certified, among other things, that (i) the reports did not contain any untrue statement of a material fact or any material omissions, (ii) the financial statements and related information fairly presented WRC's financial condition and results of operations, and (iii) he was responsible for establishing and maintaining disclosure controls and procedures.

RELEVANT ENTITY

11. WRC Media, Inc., was at all relevant times a Delaware corporation with its principal place of business in New York, New York. WRC had \$152 million of debt securities registered with the Commission pursuant to the Securities Act of 1933 that trade on the Over the Counter Market. In its Form S-4 registration statement, WRC agreed to provide the note holders, so long as any notes were outstanding, quarterly and annual reports on Forms 10-Q and 10-K, as well as all current reports on Form 8-K, in compliance with Commission rules and regulations. During all relevant times, WRC filed consolidated financial statements and reported the subsidiaries' individual financial performance in its Form 10-Qs and 10-Ks.

FACTS

12. During 2002, WRC was in poor financial condition because many school districts lacked the funds to purchase educational software and related supplemental materials.

13. WRC reported a net loss of just over \$4 million during the first half of 2002, on revenue that was down about \$7.5 million or 14.5% from mid-year 2001. Due to the unfavorable business climate, it appeared unlikely that WRC's performance would improve in the second half of 2002. By the beginning of the fourth quarter, Compass' revenue was down \$16 million from 2001.

14. In the fourth quarter, WRC needed to generate nearly \$20 million in sales to meet revenue forecasts. Without this revenue, WRC was in danger of violating two liquidity ratios (calculated for compliance quarterly) relating to its public debt agreements. If the ratios were not met, a default could have been triggered that would require the acceleration of principal payments and the denial of further financing under WRC's credit revolver.

15. Both liquidity ratios compared a modified EBITDA (earnings before interest, depreciation, taxes and amortization) amount to the company's total of long and short-term debt, which made the amount of revenue recognized by WRC material to the calculations. In July 2002, WRC revised downward its 2002 EBITDA projections and renegotiated its credit agreement to reduce the amount of liquidity required. Despite the reduction, in the fourth quarter of 2002, WRC was still in danger of violating the debt covenants due to weak sales.

16. Kenney regularly monitored WRC's "key accounts" summary report, which listed large potential sales that could close during the quarter. During the fourth quarter of

2002, Kenney knew the Monroe account was very important to WRC's fourth quarter revenue expectations and to its ability to satisfy debt covenants.

October Agreement with Monroe

17. In April 2002, Compass started negotiations with the superintendent of the Monroe City School District. The initial proposal was for the school district to purchase \$2.5 million of educational software programs. Through September 2002, Compass' sales staff repeatedly met with the superintendent and other Monroe school personnel to discuss Monroe's software needs. Although the superintendent expressed interest, an agreement that he could present to the school board was not reached.

18. In October 2002, the salesperson responsible for Monroe enlisted Kenney's help on the account by asking him to meet with the superintendent in Louisiana. It was believed that having WRC's CEO personally involved in the negotiations would help close the deal and impress the superintendent.

19. Kenney traveled to Monroe, Louisiana in October 2002 to meet with the superintendent. At the meeting, Kenney and the Compass' sales staff presented the superintendent with a standard-form Compass sales contract, which, among other things, contained the following representation concerning the signing party's authority:

PURCHASE AUTHORIZATIONS

School/District represents and warrants that it has complied with any and all requirements necessary to authorize the execution of all Agreements with CompassLearning and the signing party(ies) are authorized to sign on behalf of School/District.

20. The superintendent was not statutorily authorized to contract or obligate funds on behalf of the school board. Any agreement with the Monroe City School District required the consideration and approval of the entire Monroe City School Board.

21. The superintendent did not agree to sign the standard sales contract. He told Kenney and the Compass sales staff that the school board had to approve the proposed contract and that the contract was contingent pending such approval. As a result, the superintendent told them that the words “pending board approval” would have to be added to Compass’ standard contract form.

22. Upon his return from Monroe, Kenney summarized his meeting with the superintendent in an October 20, 2002 email to a senior Compass executive. Among other things, Kenney reported that “we left Monroe with a commitment that the superintendent would provide us a letter of commitment that would indicate intent to purchase at the amount presented subject to board approval. The board meeting on November 19 is the formal board meeting for approval . . . it has to be approved by the board before we get a po [purchase order].” Around the same time, Kenney drafted a written presentation for the superintendent to use at the upcoming board meeting describing the merits of the Compass software.

23. Pursuant to the superintendent’s request, Kenney had Compass insert the “pending board approval” language in section 3.A of the standard contract. On October 24, 2002, the superintendent the agreement.

24. The salespersons responsible for the Monroe account consulted with Compass’ President to inquire whether Compass could book the revenue from the Monroe sale if the contract was contingent upon school board approval. The President informed them that revenue recognition was not appropriate until the board approved the deal. Kenney later was informed of this accounting determination. Thus, the agreement was never signed by a Compass representative because revenue recognition was not permitted until the contingency was met.

25. Under GAAP, revenue cannot be recognized until it is both earned and realized (or realizable). Statement of Position 97-2, Software Revenue Recognition, states that revenue recognition is appropriate when persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the seller's price to the buyer is fixed or determinable, and collectibility is reasonably assured.

Mounting Debt Covenant Crisis and
Failure to Obtain Board Consideration or Approval

26. On October 24, 2002, Kenney learned, through an email from WRC's CFO addressing the fourth quarter key accounts, that Compass was about \$3 million behind its revenue forecasts and \$2.7 million behind in its EBITA forecast. The email described various cost cutting options, including pay cuts and layoffs, and concluded: "None of these are easy decisions, but neither are the consequences of not only violating covenant [sic] we just recut, but missing them by a mile."

27. On November 1, 2002, WRC's CFO sent another e-mail to Kenney advising him that "our latest year end forecast shows us to be in breach of our revised debt covenants." The email further implored, "we need to hit the current forecasts the units submitted, with Compass slightly exceeding its forecast and hitting approximately \$20 million in revenue."

28. On November 5, 2002, WRC's Board of Directors weighed in on the mounting crisis with the debt covenants. They sent a memo to Kenney and other senior officers expressing their continued concern with "our ability to achieve our fourth quarter revenue forecast, particularly at CompassLearning."

29. Due to the inability to record revenue until the contingency was satisfied, the Compass sales staff continued visiting the superintendent in Louisiana during November and

December to assist him in securing the necessary board approval. During this time, Kenney received "key account" reports that provided weekly updates on the status of the sale to Monroe and the schedule for the board's consideration.

30. On November 20, the "key account" report stated that the superintendent had pulled the Monroe deal off the November 19 board calendar because one or two of the seven board members were considering tabling the decision for sixty days. According to the key account report, the superintendent wanted to ensure the other five board members would vote against tabling the decision. The report concluded by noting that consideration of the proposed contract was rescheduled for the December 10 board meeting.

31. The December 3 "key account" report noted that the board would not consider the Compass transaction until December 17.

32. In the first week of December 2002, the superintendent informed one of Compass' sales staff that the purchase from Compass would not be considered until 2003 because the outgoing school board chairman did not want to discuss the allocation of funds for the remainder of his term. The Compass sales person advised Kenney, as did the key account entry for December 11, that school board did not want to consider the purchase until 2003.

33. Because no board approval would be forthcoming in 2002, Kenney knew that Compass would not be able to satisfy the board approval contingency in that year thus making revenue recognition in the fourth quarter of 2002 inappropriate under GAAP.

December Agreement with Superintendent

34. Nevertheless, on December 11, 2002, Kenney returned to Louisiana with the Compass sales team for the sole purpose of having the superintendent sign a replacement

agreement. The superintendent suggested that they wait until after January 1, 2003, because the board would not approve anything during 2002. However, Kenney insisted that the superintendent sign another agreement.

35. The contract presented to the superintendent on December 12th, however, was not the standard, pre-printed sales agreement used in virtually every Compass sales transaction. Rather, the contract provided to the superintendent was a “customized” and substantially truncated version that, among other things, did not include the clause requiring the superintendent to represent that he was “authorized to sign on behalf” of the school board and that “all requirements necessary to authorize the execution” of the agreement had been satisfied. This version also omitted the school board approval contingency in order to conceal it from WRC’s internal accountants and independent auditors. The agreement was presented to the superintendent while Kenney was in Louisiana and had been provided to Kenney in draft form by email on December 10, 2002.

36. After signing the agreement, the superintendent specifically and repeatedly told Kenney and the Compass sales team that school board approval was still needed.

37. Securing the unauthorized contract was not enough for Kenney to complete the steps necessary to allow for the improper revenue recognition. As Kenney knew that Compass’ accounting department would only record revenue if Compass shipped the software, he asked the superintendent to accept shipment of the software and textbook materials by December 31. However, the superintendent did not want a truckload of textbook materials delivered because, among other reasons, the board had not approved the contract. Kenney requested that the superintendent agree to accept a “minimum shipment,” which consisted of one box of software CD’s and manuals.

38. Kenney then had the replacement contract forwarded to Compass' accounting department to record the revenue. However, Kenney failed to disclose the school board approval contingency to them, and the Compass Controller approved fiscal 2002 revenue recognition on the Monroe contract.

39. Consequently, Compass improperly recorded nearly \$1.2 million in revenue in the fourth quarter of 2002 and materially overstated revenue and other reported measures of financial performance and understated WRC's reported net loss by about 10%. On March 24, 2003, WRC issued a press release on Form 8-K reporting fourth quarter results, which included the fraudulently recognized Monroe revenue and failed to disclose the contingency relating to the Monroe contract. Those false financial results were included in WRC's fiscal 2002 Form 10-K, filed on March 31, 2003.

40. Kenney authorized WRC's fiscal 2002 earnings press release and certified company's fiscal 2002 Form 10-K when he knew or was reckless in not knowing that such reports were materially false and misleading. Kenney made similar misrepresentations in a March 26, 2003 investor conference call discussing WRC's fourth quarter financial review.

41. Kenney also signed a management representation letter to WRC's independent auditors on March 7, 2003. In the letter, Kenney falsely certified in paragraph 1 that "[t]he financial statements referred to above [WRC's 2002 Form 10-K] are fairly presented in conformity with accounting principles generally accepted in the United States of America." In addition, Kenney falsely certified in paragraph 42 that "[w]e have fully disclosed all sales terms, including all rights of return or price adjustments and all warranty provisions."

42. Although he knew that the Monroe contract was material to WRC's fourth quarter results, Kenney determined that no fanfare be made and that no press release issued until 2003, when the contract was expected to be finalized.

Creation of Bad Debt Reserve for Monroe "Receivable"

43. In April 2003, after the company had filed its fiscal 2002 results, the superintendent informed Compass that the school board would not consider the proposed transaction. As a result, it became clear that the Monroe City School District would not complete the transaction and that the revenue improperly recorded in the fourth quarter of 2002 would never be collected. Nonetheless, Kenney took further steps to conceal the fraud.

44. Recognizing that the Monroe transaction was itself material to WRC's quarterly results, Kenney caused WRC to disclose the transaction in WRC's quarterly report for the first quarter of 2003. However, Kenney again did not disclose the contingency or the true nature of the December agreement with the superintendent to WRC's internal accountants and independent auditors. Instead, Kenney allowed WRC to record a bad debt reserve in the first quarter of 2003 for the purported Monroe "receivable."

45. In WRC's Form 10-Q, certified by Kenney, WRC falsely attributed the bad debt reserve "to the uncertainty of collection of the receivable which resulted from a change in financial condition of [the Monroe City School Board]." Kenney discussed the increase to the bad debt reserve in a May 15, 2003 press release reporting WRC's first quarter 2003 financial results and an investor conference call on May 20, 2003. In truth, there was never a valid "receivable" for the Monroe sale, and the recording of the bad debt reserve was incorrect and violated GAAP. As the Monroe sale did not meet the criteria under GAAP for revenue recognition for the year ended December 31, 2002, WRC should never have

recorded the revenue in the first instance. Instead, WRC should have restated Fiscal 2002 revenue. Nevertheless, Kenney certified WRC's quarterly report for the first quarter of 2003 when he knew or was reckless in not knowing that such report was materially false and misleading.

Restatement to Correct Improper Accounting

46. Under GAAP, an accounting "error," as defined by APB 20, results from mathematical mistakes, mistakes in the application of accounting principles, or oversight or misuse of facts that existed at the time the financial statements were prepared. Restatement of prior period financial statements is required by GAAP upon the discovery of a material accounting error(s) in previously issued financial statements.

47. Ultimately, the truth about the Monroe transaction was revealed in early 2004. Upon discovery of Kenney's concealment of the board contingency, WRC's internal accountants and independent auditors determined that a restatement was required. In so doing, they determined that the prior accounting was in error and that the amount of error -- the \$1.2 million in Monroe revenue improperly recognized in December 2002 -- was material.

48. On March 30, 2004, WRC filed a Form 8-K disclosing the restatement of, among other items, the improper recognition of the Monroe revenue after determining that the Monroe agreement did not meet the criteria under GAAP for revenue recognition. Further, WRC determined that it had incorrectly recorded the related bad debt reserve. In the Form 8-K, signed and certified by Kenney, WRC explained the correction of the prior period accounting errors as follows:

[W]e have restated our previously audited consolidated balance sheets as of December 31, 2001 and 2002, and the related statements of stockholders'

deficit and operations for the years ended December 31, 2001 and 2002. The restatement corrects certain errors made in the application of accounting principles generally accepted in the United States of America (“GAAP”) and corrects certain of our historical accounting policies to conform to GAAP. . . .

In December 2002, the Company recorded a \$1,860 receivable of revenue from the sale of educational software and services to a school district [Monroe City]. . . . The Company has concluded that the sale did not meet the criteria under GAAP for revenue recognition for the year ended December 31, 2002, and that it incorrectly recorded the related bad debt reserve and retained the excess allowance for doubtful accounts in 2003. The Company has corrected these errors by reversing these transactions.

49. Subsequently, Kenney represented and certified in WRC’s Form 10-Q filed on May 14, 2004 and in WRC’s Form 10-K filed on June 15, 2004 that the restatement corrected certain errors made in the application of GAAP and that the Monroe sale did not meet the criteria for revenue recognition under GAAP.

50. Kenney’s certification of the restated financial statements and disclosures constitutes an admission by Kenney that GAAP prohibited revenue recognition for the Monroe transaction given the facts existing at the close of 2002 (the superintendent’s lack of authority, the board contingency, and the failure to obtain board approval in 2002).

CLAIM

SECURITIES FRAUD

Violations of Section 10(b) of the Exchange Act and Exchange Act Rule 10b-5

51. The Commission re-alleges and incorporates by reference the allegations contained in paragraphs 1 through 50 above.

52. As set forth more fully above, Kenney directly or indirectly, by use of the means or instrumentalities of interstate commerce, or by the use of the mails, or by the use of

the facilities of a national securities exchange, in connection with the purchase or sale of securities, has employed devices, schemes, or artifices to defraud, has made untrue statements of material facts or omitted to state material facts necessary in order to make the statements made, in the light of the circumstances in under which they were made, not misleading, or has engaged in acts, practices or courses of business which have operated or would operate as a fraud or deceit upon any person.

53. By reason of the foregoing, Kenney, directly or indirectly, violated or aided and abetted violations of Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder.

PRAYER FOR RELIEF

WHEREFORE, the Commission respectfully requests that this Court enter a judgment:

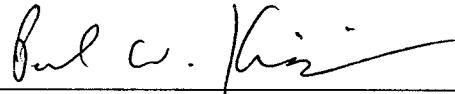
- A. Permanently restraining and enjoining Kenney from violating, directly or indirectly, Section 10(b) of the Exchange Act [15 U.S.C. § 78j(b)] and Rule 10b-5 promulgated thereunder [17 C.F.R. § 240.10b-5];
- B. Ordering Kenney to pay a civil monetary penalty pursuant to Section 21(d)(3) of the Exchange Act [15 U.S.C. § 78u(d)(3)];
- C. Prohibiting, pursuant to Section 21(d)(2) of the Exchange Act [15 U.S.C. § 78u(d)(2)], Kenney from serving as an officer or director of any issuer that has a class of securities registered pursuant to Section 12 of the Exchange Act [15 U.S.C. § 781], or that is required to file reports pursuant to Section 15 of the Exchange Act [15 U.S.C. 78o(d)]; and
- D. Granting such other and additional relief as this Court may deem just and proper.

JURY TRIAL DEMAND

The Commission hereby demands a jury trial.

Dated: September 13, 2005

Respectfully submitted,



Paul W. Kisslinger (PK 0764)

Antonia Chion

Robert W. Pommer III

Howard A. Scheck

Thomas C. Swiers

Attorneys for Plaintiff

Securities and Exchange Commission

100 F Street, N.E.

Washington, D.C. 20549-4010-A

(202) 551-4427 (Kisslinger)

(202) 551-4479 (Pommer)

(202) 772-9245 (Fax)