

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26
27
28

**UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF CALIFORNIA**

SECURITIES AND EXCHANGE
COMMISSION,

Plaintiff,

v.

LOUIS V. SCHOOLER and FIRST
FINANCIAL PLANNING
CORPORATION, dba Western
Financial Planning Corporation,

Defendants.

CASE NO. 3:12-cv-2164-GPC-JMA

**NOTICE OF TENTATIVE
AMENDMENT TO THE COURT'S
ORDER ON THE SEC'S INITIAL
MOTION FOR SUMMARY
JUDGMENT**

[ECF No. 1029]

I. INTRODUCTION

Pursuant to Federal Rule of Civil Procedure 54(b), the Court finds it appropriate to amend its April 3, 2015, Order Denying the SEC's Motion for Partial Summary Judgment on its Fourth Claim for Relief. (ECF No. 1029.) The Court's prior order incorrectly set forth the law regarding which party bears the burden of proving an affirmative defense on summary judgment under Federal Rule of Civil Procedure 56. (See ECF No. 1029, at 3–4.) With a correct interpretation of the law, the Court finds that SEC's initial motion, (ECF No. 685), must be granted in part and denied in part, reversing the Court's initial determination in the April 3, 2015, Order. Citing *Sec. and Exch. Comm'n v. Murphy*, 626 F.2d 633, 641 (9th Cir. 1980), Defendants had argued that, on summary judgment, the evidentiary burden is on the SEC to disprove an

1 affirmative defense to a registration violation. (ECF No. 980, at 4.) However, this
2 aspect of *Murphy* was overturned by *Celotex Corp. v. Catrett*, 477 U.S. 317, 323
3 (1986) (Rule 56 does not require the moving party to “negate[] the opponent’s claim.”)
4 (emphasis omitted). Thus the Court finds it appropriate to amend the April 3, 2015,
5 order’s sections regarding Rule 506(b) and disgorgement. The Court now provides
6 notice of its tentative ruling on these issues.

7 **II. DISCUSSION**

8 **A. Rule 506(b)**

9 The SEC argue that Western’s sales of GP units do not satisfy Rule 506(b)’s
10 conditions for three reasons: (1) Western failed to provide required information to non-
11 accredited investors, (2) Western engaged in general solicitation, and (3) Western
12 exceeded the limit on purchasers. (ECF No. 1019, at 7–16.)

13 **1. Purchaser Limit**

14 Rule 506(b) requires that there be no more than 35 purchasers, excluding
15 accredited investors, in the offering. 17 C.F.R. §§ 230.501(e)(1)(iv), 230.506(b)(2).
16 Included within the definition of “accredited investor” is “[a]ny natural person whose
17 individual net worth, or joint net worth with that person’s spouse, exceeds \$1,000,000.”
18 *Id.* § 230.501(a)(5). The SEC argues that, because there were “3,400 investors in the
19 defendants’ single, integrated offering of GP securities,” “the registration exemption
20 cannot be invoked.” (ECF No. 1019, at 16.) Defendants attempt to rebut this argument
21 by pointing to the fact that two GPs have less than 35 investors. (ECF No. 980, at 7.)
22 However, the Court has already concluded that all the GPs constitute a single,
23 integrated offering and thus the fact that two GPs have less than 35 investors does not
24 show that the entire offering has less than 35 non-accredited investors. Accordingly,
25 the Court finds that Defendants have failed to carry their burden on Western’s Rule
26 506(b) affirmative defense. The Court will, however, address the remaining disputes
27 concerning Rule 506(b).

28 //

1 **2. Information Requirement**

2 Rule 506(b) further requires that an issuer must provide certain kinds of
3 information to any non-accredited investor purchaser. 17 C.F.R. § 230.502(b). The
4 SEC argues that, because Schooler stated that “Western did not provide any financial
5 statements to prospective investors,” “it is undisputed that the [information
6 requirement] has not been met.” (ECF No. 1019, at 8 (quoting ECF No. 980-2 ¶ 8).)
7 Defendants argue that “Western reasonably believed that non-accredited investors,
8 either alone or with a purchaser representative, possessed the ‘knowledge and
9 experience in financial and business matters’ to fairly evaluate ‘the merits and risks of
10 the prospective investment.’” (ECF No. 980, at 10 (citations omitted).) But Rule 506(b)
11 does not exempt non-accredited investors from the information requirement based on
12 Western’s beliefs about the investors’ financial expertise; only accredited investors are
13 exempted from the information requirement. 17 C.F.R. § 230.502(b)(1). Accordingly,
14 the Court finds that Defendants have failed to carry their burden to show that the
15 required information was provided to non-accredited investors.

16 **3. General Solicitation**

17 Rule 506(b) also prohibits an issuer or “any person acting on its behalf” from
18 selling or offering to sell securities “by any form of general solicitation or general
19 advertising.” 17 C.F.R. § 230.502(c). The SEC cites eleven sources of evidence to
20 support its contention that Western engaged in general solicitation or advertising of GP
21 units, primarily relying upon Schooler’s statements with regards to cold calls. (ECF No.
22 685-2, at 1; ECF No. 1019, at 9–15.)

23 Contrary to the SEC’s arguments, the Court finds that the evidence cited by the
24 parties indicates a dispute of material fact as to whether the GP units were generally
25 solicited or advertised by Western. First, Rule 506(b) prohibits offering or selling
26 securities through general solicitation or advertising, but does not prohibit obtaining
27 clients through such methods. *See* 17 C.F.R. § 230.502(c). Indeed, the SEC has issued
28 a no action letter recognizing that offers to clients obtained through general solicitation

1 may not constitute general solicitation if “sufficient time” passes “between
2 establishment of the relationship and [the] offer.” *Sec. and Exch. Comm’n v. Credit*
3 *First Fund LP*, No. 05-cv-8741-DSF-PJWx, 2006 WL 4729240, at *12 (C.D. Cal. Feb.
4 13, 2006) (quoting E.F. Hutton & Co., No-Action Letter, 1985 SEC No-Act. LEXIS
5 2917 (Dec. 3, 1985)). Second, Western argues that its sales agents were selling the GP
6 units on behalf of a third party, not Western. (ECF No. 980, at 7–10.) Third, an
7 unknown number of cold calls or mailings to a geographic area of unknown size may
8 not necessarily qualify as general solicitation or advertising. *Cf. Sec. and Exch.*
9 *Comm’n v. Tecumseh Holdings Corp.*, No. 03-cv-5490-SAS, 2009 WL 4975263, at *4
10 (S.D.N.Y. Dec. 22, 2009) (noting that a “nationwide cold-calling campaign has many
11 of the same characteristics as the examples listed in 502(c)” because of three factors:
12 “(1) it has the potential to reach a large number of people; (2) it has the potential to
13 reach people throughout a large geographic area; and, perhaps most importantly, (3)
14 it generally targets people with whom the issuer does not have a prior relationship and
15 who are unlikely to have any special knowledge about the offered security”) (emphasis
16 added).

17 **B. Disgorgement**

18 The SEC argues that the amount of money raised from investors, \$152,982,250,
19 is the proper amount of disgorgement. (ECF No. 685-1, at 12–15.) Defendants do not
20 dispute that this was the actual amount raised from investors, but instead argue that the
21 “profits” in this case should be that amount minus certain expenses and costs. (ECF No.
22 980, at 11–13.) The Court finds that, the total amount raised from the investors in the
23 GPs that underlie the SEC’s Section 5 cause of action, \$152,982,250, is a “reasonable
24 approximation of profits causally connected to the violation” because it does not appear
25 that Western actually paid anything to buy or produce the securities themselves and
26 thus any income would be pure profit. *First Pac. Bancorp*, 142 F.3d at 1192 n.6
27 (citation and internal quotation marks omitted); *see Platforms Wireless*, 617 F.3d at
28 1096–97 (“There is no evidence in the record, and the defendants do not contend, that

1 they paid cash value for the newly-issued shares.”). The SEC also requests prejudgment
2 interest. (ECF No. 685-1, at 14.) The Court finds that an award of prejudgment interest
3 appropriate in this case. *See Sec. and Exch. Comm’n v. Moran*, 944 F. Supp. 286, 295
4 (S.D.N.Y. 1996) (“Requiring payment of interest prevents a defendant from obtaining
5 the benefit of what amounts to an interest free loan procured as a result of illegal
6 activity.”) Prejudgment interest shall be calculated through the date of the final order
7 on the SEC’s motion, in accordance with the tax underpayment rate. 26 U.S.C. § 6621;
8 *Platforms Wireless*, 617 F.3d at 1099. However, the Court rejects the prejudgment
9 interest calculated by the SEC because, as discussed below, the Court finds it
10 appropriate to reduce the disgorgement total requested by the SEC.

11 As the SEC has carried its initial burden, the Court turns to the five arguments
12 raised by Defendants why either disgorgement is unwarranted or the total proposed by
13 the SEC should be reduced: (1) that Defendants have not yet been found liable for
14 fraud, (2) that investors have received consideration for their investment, (3) that
15 legitimate business expenses are deductible, (4) that Defendants’ cost to acquire the GP
16 units are deductible, and (5) that the disgorgement total is punitive and inequitable.
17 (ECF No. 980, at 12–21.)

18 First, with regards to fraud, Defendants cite no authority for this proposition
19 other than to distinguish the facts of this case from those of *Platforms Wireless* and
20 *SEC v. JT Wallenbrock & Assocs.*, 440 F.3d 1109 (9th Cir. 2006). (ECF No. 980, at
21 14.) Courts have also awarded disgorgement in the absence of fraud. *See, e.g., Sec. and*
22 *Exch. Comm’n v. Parkersburg Wireless Ltd. Liability Co.*, 991 F. Supp. 6, 9 (D.D.C.
23 1997) (ordering disgorgement even if the defendant “had no idea that the units he was
24 selling were securities”).

25 Second, the Court does find that the investors received consideration for their
26 securities, namely the property interest that each of their GPs hold. However, the Court
27 rejects Defendants’ argument that each property’s value can only be fixed through sale.
28 It is clear to the Court that appraisals have routinely been used to value property and

1 there is no indication that an appraisal would be insufficient in this case. The Court
2 thus finds it appropriate to reduce the disgorgement amount by \$16,328,000, the
3 appraised value of the land obtained by the Receiver. (ECF No. 203, at 2)

4 Third, the Court believes that it is at least arguable that direct transaction costs
5 could be deducted, but Defendants have not satisfied their burden in this regard. The
6 Ninth Circuit in *JT Wallenbrock* specifically refused to allow “offset[s] for *entirely*
7 *illegitimate* expenses incurred to perpetrate an *entirely fraudulent* operation,” 440 F.3d
8 at 1115 (emphasis in original), which leaves open the question of whether legitimate
9 expenses can be deducted from a disgorgement total and what kinds of expenses are
10 considered legitimate. It is true that the vast majority of courts have found that business
11 expenses cannot be deducted in any case. *See, e.g., Sec. and Exch. Comm’n v. Brown*,
12 658 F.3d 858, 861 (8th Cir. 2011). That said, a significant number of courts, primarily
13 in the Second Circuit, have found certain business expenses deductible. *See, e.g., Sec.*
14 *and Exch. Comm’n v. Universal Exp., Inc.*, 646 F. Supp. 2d 552, 564 (S.D.N.Y. 2009);
15 *Thomas James*, 738 F. Supp. at 95. However, contrary to Defendants’ argument, it is
16 not “general business expenses, such as overhead expenses,” that these courts find
17 deductible, but rather “direct transaction costs . . . that plainly reduce the wrongdoer’s
18 actual profit.” *Universal Exp.*, 646 F. Supp. 2d at 564 (citations and internal quotation
19 marks omitted); *see also Thomas James*, 738 F. Supp. at 94 (“In determining the proper
20 amount of restitution, a Court may consider as an offset the sums which a defendant
21 paid *to effect* a fraudulent transaction.”) (emphasis added). Thus Defendants
22 submission of Western’s general tax documents for the years 1984 through 1986 and
23 1988 through 2012, (ECF Nos. 980-2–980-12, Exs. 3–30), would not satisfy their
24 burden to show direct transaction costs even if the Court were to consider such costs
25 deductible.

26 Fourth, acquisition costs should not be deducted in this case for two reasons.
27 First, the Court is already deducting for the value of the property transferred to the GPs
28 and thus deducting for acquisition costs would be double dipping. Second, Defendants

1 peeled off valuable portions of several of the properties before selling them to the GPs
2 and thus it would be inequitable to deduct the costs of these properties when they were
3 not entirely transferred to the GPs.

4 Fifth, the Court does not find the disgorgement amount to be punitive. The
5 purpose of disgorgement is to account for the profits gained in violation of the
6 securities laws; the focus is on the Defendants' current violations, not the investors.
7 *Wyly*, 2014 WL 3739415, at *2 (citation omitted). Defendants' citation to *Rind*
8 regarding remoteness in time is unavailing because the two cases that *Rind* cites, *SEC*
9 *v. Willis*, 777 F. Supp. 1165 (S.D.N.Y. 1991), and *SEC v. Glick*, No. cv-LV-78-11,
10 1980 WL 1414 (D. Nev. June 12, 1980), found remoteness in time relevant when
11 deciding whether to issue injunctive relief, not disgorgement. *See Willis*, 777 F. Supp.
12 at 1174; *Glick*, 1980 WL 1414, at *2. This makes sense because the standard for
13 injunctive relief explicitly considers the likelihood that the violations will be repeated.
14 (ECF No. 44, at 22 ("A preliminary injunction is appropriate if there is a prima facie
15 case that Defendants have violated the securities laws and a reasonable likelihood that
16 their violations will be repeated."))

17 In sum, the Court finds that the SEC has carried its burden with regards to the
18 initial figure of \$152,982,250, and that Defendants have carried their burden as to a
19 reduction for the consideration transferred to investors, which the Court values at the
20 23 properties' \$16,328,000 appraised value. Thus the Court determines the appropriate
21 disgorgement amount to be \$136,654,250 plus prejudgment interest calculated to the
22 date of the final order on the SEC's motion.

23
24 DATED: May 14, 2015

25 
26 HON. GONZALO P. CURIEL
27 United States District Judge
28