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UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF CALIFORNIA

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

vs.

LOUIS V. SCHOOLER and FIRST FINANCIAL PLANNING CORPORATION d/b/a WESTERN FINANCIAL PLANNING CORPORATION,

Defendants.

Case No. 12 CV 2164 GPC JMA

SECURITIES AND EXCHANGE COMMISSION'S RESPONSE TO THE RECEIVER'S MOTION FOR (A) AUTHORITY TO CONDUCT ORDERLY SALE OF GENERAL PARTNERSHIP PROPERTIES; (B) APPROVAL OF PLAN OF DISTRIBUTING RECEIVERSHIP ASSETS; AND (C) APPROVAL OF PROCEDURES FOR THE ADMINISTRATION OF INVESTOR CLAIMS

Dkt. No. 1181

Ctrm: 2D
Judge: Hon. Gonzalo P. Curiel

I. INTRODUCTION

Plaintiff Securities and Exchange Commission ("SEC") submits this response to the receiver's motion seeking Court authority to conduct orderly sales of general partnership properties, and Court approval of the receiver's proposed plan for distributing estate assets and for administering investor claims (Dkt. No. 1181). The SEC has reviewed the motion, and supports the receiver's proposals in full.

II. THE SEC'S POSITION ON THE RECEIVER'S PROPOSALS

A. The SEC Supports The Receiver's Recommendation For An Orderly Sale Of Receivership Assets

In his motion, the receiver proposes the orderly sale of the general partnership properties. *See* Dkt. No. 1181 ("Receiver Mot.") at 7-11. The SEC agrees with the receiver's recommendation. As the receiver points out in his motion, "money is rapidly being spent to hold properties that are not measurably increasing in value." *Id*. at 3. Only nine properties have materially increased in value; the rest have not. *See id*. In fact, three properties may be worth less than the mortgages encumbering them, rendering them worthless to the estate and the investors. *See id*. The orderly sale of receivership assets proposed by the receiver, therefore, is the best way to return capital to the estate so it can be distributed to the investors who were the victims of the fraud and illegal, unregistered offerings perpetrated by the defendants.

In its April 5, 2016 order postponing the hearing on the receiver's motion, the Court asked the receiver "to craft a proposal that would enable general partnerships ('GPs') that wish to do so to exit the receivership while maintaining control of their properties instead of having their properties sold," and to provide the Court with an assessment of the "advantages and disadvantages" of allowing such an exit. Dkt. No. 1224 at 2. That receivership submission is due next week, on April 22, 2016. *See id*.

The Court has previously considered the dire consequences of allowing general partnerships to exit the estate where "Western has essentially intertwined its assets with those of investors by taking an interest in at least one GP that owns almost every

GP property and holding notes from nearly two-thirds of GPs," and determined that keeping the general partnerships in the receivership would be the "only practical" and "most equitable" thing to do. Dkt. No. 1003 at 18-19; *see also* Dkt. No. 880 (SEC submission outlining reasons and legal precedent supporting keeping general partnerships in the receivership estate). The SEC respectfully submits that the reasons for keeping the general partnerships in the receivership are just as compelling, if not more so, now, during an orderly sale of assets, as they were back in March 2015 when the Court issued that ruling.

In short, the SEC fully supports the receiver's proposal for the orderly sale of receivership assets. Meanwhile, the SEC awaits the receiver's proposal and analysis of the pros and cons for the potential exit of general partnerships from the estate.

B. The SEC Supports The "One Pot Approach" Distribution Plan

This Court, as the one administering an equity receivership, has the inherent powers to fashion any distribution plan that is fair and equitable. *See SEC v. Capital Consultants, LLC*, 397 F.3d 733, 738-739 (9th Cir. 2005) (recognizing that the Ninth Circuit "has noted that equity demands equal treatment of victims in a factually similar case"); *SEC v. Sunwest Management, Inc*., No. 09-6056-HO, 2009 WL 3245879, at *8 (D. Or. Oct. 2, 2009) (*citing SEC v. Hardy*, 803 F.2d 1034, 1037 (9th Cir.1986); *SEC v. Wang*, 944 F.2d 80, 84-85 (2d Cir. 1991); *see also SEC v. Basic Energy & Affiliated Res., Inc.*, 273 F.3d 657, 670-71 (6th Cir. 2001); *SEC v. Elliott*, 953 F.2d 1560, 1566 (11th Cir. 1992). "In approving a plan of distribution in an SEC receivership case, the court must determine the most equitable distribution result for all claimants, including investors." *Sunwest Management*, 2009 WL 3245879 at *9.

The receiver has proposed a "One Pot Approach" for the distribution of receivership assets to the investors. *See* Receiver Mot. at 13, 21. Under that proposed plan, the receiver would pool "all net sale proceeds from all GP properties" and distribute those proceeds, *pro rata*, "to all investors based on the total funds they invested." *Id*. at 13. In proposing this plan, the receiver noted an alternative method

for distributing assets—the "Two Tier Approach"—where property sale proceeds would first go to the general partnerships that own the property and then, after any debts owed by the general partnerships to Western are paid, Western's assets would be distributed to all investors on a *pro rata* basis. *See id*. The receiver recommends the "One Pot Approach" over the "Two Tier Approach" for the distribution plan because, in the view of the receiver, the "One Pot Approach" is "more fair and equitable." *Id*. at 17. The receiver makes this recommendation based on his investigation of the affairs and operations of the receivership entities, his forensic accounting of those entities' financial transactions, and his management of the entities for the past three years and four months.

Having carefully considered the circumstances of this case and having reviewed the receiver's proposal, as well as his rationale for choosing the "One Pot Approach," the SEC agrees that this method is the most fair and equitable method to distribute the receivership assets. Under the "One Pot Approach," the receiver estimates he would be able to distribute about $21.8 million to all investors on a *pro rata* basis, yielding a projected 13.4% recovery for each. *See id*. at 13. The "Two Tier Approach," however, would tie investor recoveries to whichever partnership each investor was in, and lead to a highly inequitable distribution that would benefit a few investors but harm many more. Under that approach, only about $1.2 million would be available for equal distribution to all investors; the rest (about $21.6 million) would be distributed partnership-by-partnership, with the majority of that going to a small group of investors. *See id*. at 13-14. Thus, the receiver estimates that some investors would get little as 0.75% in recoveries, while others would receive as much as 194.07%. *See id*.[1] That is, were the receiver to undertake anything other than an equal, *pro rata* distribution (like the "One Pot Approach"),

[1] The receiver has explained that actual recoveries may vary significantly from these projections depending on when reasonable offers are received, court approval is obtained, and the transactions close.

many defrauded investors would get pennies in recovery, while a small handful could almost double their money.

The inequity of a distribution plan that does not pool all the receivership assets for a *pro rata* distribution is amplified because certain investors would receive greater recoveries under such a plan due to factors beyond their control. For example, whether or not an investor would receive large recoveries would depend on the luck in the timing of their investment in the Western enterprise, the existence of undisclosed mortgages that encumbered some, but not all, properties, or the markup Western and Schooler charged on the property, which could range from 109% to 1800%. *See* Dkt. No. 1181-1 at 17-18. Recoveries would thus be arbitrarily tied to the actions of Western and Schooler, the very parties who defrauded or illegally sold securities to these investors without providing the information they would have received in a registration statement. *See Sunwest Management*, 2009 WL 3245879 at *9 (*citing United States v. Durham*, 86 F.3d 70, 72 (5th Cir. 1996)) (finding that distributing investor funds separately would be inequitable because it would allow greater recovery by certain investors on the arbitrary basis of the actions of the defendants).

In addition, the "One Pot Approach" makes the most sense given the way in which the defendants ran the Western enterprise. In particular, and as the Court has found, the assets of all of the general partnerships and those of Western were closely "intertwined" and investor funds were commingled. *E.g.*, Dkt. No. 1003 at 2:8-10 n.1. "Courts have favored *pro rata* distribution of assets where, as here, the funds of the defrauded victims were commingled and where victims were similarly situated with respect to their relationship to the defrauders." *SEC v. Credit Bancorp, Ltd.*, 290 F.3d 80, 88-89 (2nd Cir. 2002) (*citing Cunningham v. Brown*, 265 U.S. 1, 13 (1924)); *see also SEC v. Malek*, 397 Fed. Appx. 711, 715-716 (2d. Cir. 2010). As the Supreme Court put it, "where investors' assets are commingled and the recoverable assets in a receivership are insufficient to fully repay the investors, 'equality is

equity.'" *SEC v. Wealth Management LLC*, 628 F.3d 323, 333 (5th Cir. 2010) (*quoting Cunningham*, 265 U.S. at 13); *Sunwest Management*, 2009 WL 3245879 at *10 ("[a] substantial body of case law concerning distributions through federal equity receiverships supports equitable pooling of the assets of receivership entities in order to enable pro rata distributions to investors" where investor funds have been commingled) (*citing CFTC v. Eustace*, No. 05-2973, 2008 WL 471574, at *6 (E.D. Pa. Feb. 15, 2008) (*citing CFTC v. Topworth Int'l, Ltd.*, 205 F.3d 1107 (9th Cir. 1999))).

The commingling of funds and intertwining of investor interests here were extensive and well established. The Court has already found that "Western's sales of GP units for all the GPs [was] a single, integrated offering." Dkt. No. 1074 at 8. It further found that "[t]he sales of GP units were part of a single plan to finance Western's operations (*see* ECF No. 182, at 7 ('Approximately 93% of the actual cash collected by the GPs was transferred to Western.'))." *Id.* at 7. Also, on average, about 93% of the investor funds raised in the offering were transferred by each general partnership to Western. *See* Dkt. No. 182 (receiver report) at 7:20-21 ("Approximately 93% of the actual cash collected by the GPs was transferred to Western."). Those funds were then used to pay expenses related to other general partnerships, including mortgage payments Western owed on various properties (*see* Dkt. No. 504 at 4), the purchase prices for land that would be sold to future general partnerships (*see id*. at 2-3), and uncollected and undisclosed "loans" to GPs that had insufficient funds to cover their own expenses. *See* Dkt. No. 571-1 (def. stmt. of facts) at ¶¶ 57, 59; Dkt. No. 1148 (receiver report) at 7-8.

That is, for every $1.00 raised from each investor, more than 90 cents was commingled with other investor money and used for a variety of purposes, often having nothing to do with the general partnership that the investor was in. In fact, for many investors, during the first two years of investment, investors had no separate investment because their general partnerships had not been formed yet. *See* Dkt. No.

583 at 4-6, 15-16. Under these circumstances, a one-pot distribution approach is the most equitable method of distributing assets to injured investors. *See Sunwest Management*, 2009 WL 3245879 at *6-8 (*pro rata* distribution plan approved where the promoter commingled investors' funds and operated a "unitary enterprise").

Even if the intertwining of investments or commingling of investor funds were not as extensive as they were here, the distribution of assets by any method other than an equal *pro rata* distribution would be unwarranted and inequitable. *See, e.g.*, *Eustace*, 2008 WL 471574 at *7 (approving a *pro rata* distribution where the commingling was sporadic in nature). Courts have approved *pro rata* distribution plans as the most equitable method to distribute assets where each investor thought he or she was investing in one of several facilities run by the issuer, where some investors had perfected an interest in a particular asset, and where an investor's funds were segregated in a separate account. *See Sunwest Management*, 2009 WL 3245879 at *1,*4, *6-8 (*pro rata* distribution plan approved in case involving sale of interests in assisted living facilities and "other … real property both related and unrelated to the assisted living facilities" (*1), where "investors were told that they were purchasing ownership interests for a specific real property" (*4), but the promoter commingled investors' funds and operated a "unitary enterprise" (*7)). For example, in *Quilling v. Trade Partners, Inc.*, the court approved a *pro rata* distribution plan where investors had purchased interests in viatical settlements, and refused to allow an exception for an investor who had a recorded ownership interest in a specific life insurance policy. *See* 572 F.3d 293, 300-301 (6th Cir. 2009); *see also SEC v. Forex Asset Management, LLC*, 242 F.3d 325, 331-332 (5th Cir. 2001) (affirming distribution plan that distributed $800,000 invested by one investor with the rest of the estate even though those funds were held in a discrete account) (*citing Durham*, 86 F.3d at 72-73 (affirming plan that distributed all funds equally on *pro rata* basis even though $70,000 of $83,000 investor funds could be traced to one investor)).

Moreover, while some investors here may argue they can trace their

investments to particular properties, even if that were true, a *pro rata*, pooled distribution is still the most equitable method to distribute assets given the extent to which investor funds were commingled here. The tracing of invested funds simply cannot yield the most equitable result when the funds of investors have been commingled in any way. *See Credit Bancorp*, 290 F.3d at 88-89; *Malek*, 397 Fed. Appx. at 715-716; *Wealth Management*, 628 F.3d at 333. For this reason, the Supreme Court has recognized that tracing principles can be suspended in order to reach the most equitable result. *See Cunningham*, 265 U.S. at 13. In any event, because on average 93 cents of every dollar invested by each investor was commingled, the tracing of investor funds to specific properties may be impossible.

Also, courts do not have to honor an individual investor's investment in a particular general partnership if doing so leads to inequitable results. Just because an investor's investment may otherwise be enforceable according to its terms does not mean the court must favor that investor by tracing his or her invested funds. Rather, the Supreme Court's principle of "equality is equity" should guide the Court. Indeed, because Western relied on commingled funds to support its operations, "all of its transactions lost [the] presumption of legitimacy." *Sunwest Management*, 2009 WL 3245879 at *9. While it is true that investors who could trace their invested funds might be able to recover them if they were seeking to enforce claims against Western, the same is not true for claims between investors—which is what a court overseeing an equity receivership should be concerned with. *See Quilling*, 572 F.3d at 301 (affirming pooling receivership assets and distributing them on a *pro rata* basis as "well-supported," particularly where investors were similarly situated with each other in their "relationship to the defrauders"). "As a matter of equity, one investor should not be permitted to benefit from a fraud at the expense of other [i]nvestors merely because he was not himself to blame for the fraud." *Sunwest Management*, 2009 WL 3245879 at *9 (*citing Scholes v. Lehmann*, 56 F.3d 750, 757 (7th Cir. 1995)). It is far more equitable for all investors to receive the same percentage of their investment

than for some investors to recover a large percentage (or even make a large profit) while others recover little or nothing.

The receiver's "One Pot Approach" achieves the "equality is equity" principle by providing all investors the same recovery. Any other method, including the "Two Tier Approach," would generate wildly unequal results for investors, which is exactly what a court's equity receiver should be striving to avoid. Here, as in many cases that involve a receivership estate with assets insufficient to cover all investors claims, regardless of the distribution approach used, some investors may have better recoveries than others depending on the distribution method used. The goal, however, should be to establish a distribution approach that treats all investors as fairly and equitably as possible. The SEC believes that the "One Pot Approach" satisfies that goal.

C. The SEC Supports the Receiver's Proposal for Administering Any Claims by Investors

In his motion, the receiver also proposes a plan for administering investor claims. *See* Receiver Mot. at 23-25. The SEC supports this plan.

III. CONCLUSION

For all the foregoing reasons, and those cited by the receiver in his motion, the SEC supports the actions proposed by the receiver.

Dated: April 15, 2016

/s/ Lynn M. Dean
John W. Berry
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PROOF OF SERVICE

I am over the age of 18 years and not a party to this action. My business address is:

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On April 15, 2016, I caused to be served the document entitled **SECURITIES AND EXCHANGE COMMISSION'S RESPONSE TO THE RECEIVER'S MOTION FOR (A) AUTHORITY TO CONDUCT ORDERLY SALE OF GENERAL PARTNERSHIP PROPERTIES; (B) APPROVAL OF PLAN OF DISTRIBUTING RECEIVERSHIP ASSETS; AND (C) APPROVAL OF PROCEDURES FOR THE ADMINISTRATION OF INVESTOR CLAIMS** on all the parties to this action addressed as stated on the attached service list:

☐ **OFFICE MAIL:** By placing in sealed envelope(s), which I placed for collection and mailing today following ordinary business practices. I am readily familiar with this agency's practice for collection and processing of correspondence for mailing; such correspondence would be deposited with the U.S. Postal Service on the same day in the ordinary course of business.

☐ **PERSONAL DEPOSIT IN MAIL:** By placing in sealed envelope(s), which I personally deposited with the U.S. Postal Service. Each such envelope was deposited with the U.S. Postal Service at Los Angeles, California, with first class postage thereon fully prepaid.

☐ **EXPRESS U.S. MAIL:** Each such envelope was deposited in a facility regularly maintained at the U.S. Postal Service for receipt of Express Mail at Los Angeles, California, with Express Mail postage paid.

☐ **HAND DELIVERY:** I caused to be hand delivered each such envelope to the office of the addressee as stated on the attached service list.

☐ **UNITED PARCEL SERVICE:** By placing in sealed envelope(s) designated by United Parcel Service ("UPS") with delivery fees paid or provided for, which I deposited in a facility regularly maintained by UPS or delivered to a UPS courier, at Los Angeles, California.

☒ **ELECTRONIC MAIL:** By transmitting the document by electronic mail to the electronic mail address as stated on the attached service list.

☒ **E-FILING:** By causing the document to be electronically filed via the Court's CM/ECF system, which effects electronic service on counsel who are registered with the CM/ECF system.

☐ **FAX:** By transmitting the document by facsimile transmission. The transmission was reported as complete and without error.

I declare under penalty of perjury that the foregoing is true and correct.

Date: April 15, 2016

/s/ Sara D. Kalin
Sara D. Kalin

SEC v. Louis V. Schooler, et al.
United States District Court—Southern District of California
Case No. 12 CV 2164 GPC JMA

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