No. 16-55850

IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

U.S. SECURITIES & EXCHANGE COMMISSION,
Plaintiff – Appellee,

v.

LOUIS V. SCHOOLER; FIRST FINANCIAL PLANNING CORPORATION,
DBA Western Financial Planning Corporation,
Defendants – Appellees,

SUSAN GRAHAM, ET AL.
Intervenors – Appellants,

THOMAS C. HEBRANK,
Receiver – Appellee.

On appeal from the United States District Court
for the southern District of California, Case No. 3:12-cv-02164-GPC-JMA

APPELLANTS' REPLY TO OPPOSITION OF THE SECURITIES AND EXCHANGE COMMISSION TO APPELLANTS' MOTION FOR STAY PENDING APPEAL

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I. Introduction

The argument below addresses all issues raised by the Securities and Exchange Commission ("SEC") in its opposition, except its argument on the due process, the Receiver's "one pot" distribution plan, and how those factors affect irreparable harm, the balancing of the equities, and public interest. Appellants[1] cannot fully address these issues without also addressing the related factual contentions urged by the receiver, Thomas C. Hebrank ("Hebrank"), in his opposition, which he filed a day late. Since the SEC and Hebrank filed their briefs six days apart, leaving Appellants one day to address these new facts, Appellants will defer their argument on these two issues until they reply to the Hebrank's opposition on October 19, 2016.

II. The SEC's Groundless Opposition to Treating This Motion as Urgent

Only the SEC opposes treating this motion as urgent. Hebrank has the duty to steward the 87 general partnerships ("GPs") in the receivership, but does not oppose treating this motion as urgent. Although Hebrank has filed opposition, he "does not object to the motion being decided on an expedited basis." His argument the Court lacks jurisdiction over the Jamul Valley property signals his inability to close that sale. Hence, he also needs a decision on the merits of this motion.

[1] The names of the Appellants are listed in Attachment 1 filed herewith.

Like Hebrank, the SEC does not dispute Appellants' grounds for treating this motion as urgent. Its silence concedes Hebrank (1) has obtained orders confirming the first two sales of GP realty (D.[2] 1360 and 1361), (2) has pooled the cash from all GP bank accounts (D. 1319 at 4), (3) can obtain orders confirming more sales in 28 days (Local Rule 7.1.e), and (4) proposes a plan that would strip investors' interests in GPs which they financially ever since. D. 1181.

Relying on *Oakland Tribune, Inc. v. Chronicle Pub. Co.*, 762 F.2d 1374, 1375-1376 (9th Cir. Cal. 1985), the SEC in effect argues this Court should allow Appellants' claims to become moot, because 30 days passed from the district court's denial of Appellants' motion for a stay until they filed with this Court. *Oakland* held that delay of "many years" before seeking an injunction to halt an alleged Sherman Act violation was too long. This Court lent perspective to *Oakland Tribune* in *Lydo Enters. v. Las Vegas*, 745 F.2d 1211, 1214 (9th Cir. Nev. 1984), observing: "We would be loath to withhold relief solely on that ground, but we do give that fact consideration in measuring the claim of urgency."

No doubt, the SEC should be able to file briefs faster than Appellants. Its workload is shared by six well qualified attorneys, including four assigned to this appeal. Appellants chose counsel with less human resources: one attorney and one paralegal. He alone represents Appellants in proceedings before this Court and the

[2] "D." refers to the corresponding docket entry in *SEC v. Schooler*, No. 12-cv-02164 (S.D. Cal.); "D.E." refers to the corresponding docket entry with this Court.

district court. And that attorney was 6,000 miles away on vacation with his family when the district court denied the motion for

a stay *one week before the hearing date it had set on the motion.* D. 1339-1 ¶¶ 3-5.

The sheer size of the record (almost 1,400 filings), the scope of the issues on appeal, the sophistication of opposing counsel, and the objective (to overturn the district court's orders) call for careful deliberation before submitting any brief to this Court. Appellants contend the district court's orders exceed its subject matter jurisdiction, violate investors' rights to due process of law, conflict with established receivership law, and conflict with SEC regulations. Getting the law and facts correct on all these issues and shoehorning them into a 25-page brief, while complying with other deadlines of this case, took all available time of Appellants' counsel and then some until the September 29 filing.

III. The Court Should Stay Hebrank from Making Cash Transactions Unless He Records Them

The SEC argues that Appellants' have mischaracterized the relief they seek as a stay when it goes beyond staying a district court order. Again, Hebrank does not join the SEC's argument, since it does not address the merits. The SEC's technical objection is groundless for two reasons. Appellants crafted the proposed stay to seek the minimal relief necessary to preserve the *status quo*. One term of the proposed stay focuses on Hebrank's broadened authority under the district court's order (D. 1304) to spend receivership cash. Hebrank explains his broadened authority to spend the newly *pooled funds* in his 15th interim report:

> [P]ursuant to the Court's May 25, 2016 Order [D. 1304], all assets of the Receivership Entities (Western and the GPs) have been pooled, past due property taxes and mortgage payments have been brought current, and property expenses are being paid from pooled funds.

D. 1319, at 5, ll. 19-21. For the first time, Hebrank may spend one GP's funds to pay the debt of a different GP. Appellants' motion could have sought a stay of any spending of these pooled funds, but this would have been more than necessary to preserve their rights. Instead, they propose Hebrank's expenditure of these funds be conditioned on his recording of his cash transactions. This would allow the district court to reinstate the separate accounts if Appellants prevail, does not constrain the receivership, and requires Hebrank to do nothing he is not already obligated to do.

The leading treatise, 2 Clark on Receivers (3d ed. 1992), confirms Hebrank's duty to record his cash transactions of receivership cash:

> It is the receiver's duty to keep an accurate account of all money received and expended. Even in the absence of objections by an interested party, a court should closely scrutinize the accounts of a receiver before approving them. … Vouchers should be demanded when any payments except petty payments are made and these vouchers preserved and filed with the receiver's report.

The SEC's reporting instructions for any receivers it recommends to the district court, and to which they must agree, provide:

> The Standardized Fund Accounting Report (SFAR) should be prepared for the reporting period on a cash basis which is a comprehensive basis of accounting other than generally accepted accounting principles. In cash basis accounting, *revenues are recorded only when cash is received and expenses* are recorded only when cash is paid (emphasis added).

See also: *In Barbara Channelkeeper v. Seror*, 2010 U.S. Dist. LEXIS 109978 (C.D. Cal.) ("The Receiver shall keep detailed accounting records of all deposits to and all expenditures from the Receiver Trust Account, and shall maintain those accounting records until the expiration the receivership.")

Finally, whether or not correctly characterized, this Court has the jurisdiction to enjoin the expenditure of the pooled funds or direct Hebrank to record cash transactions during the pendency of this appeal. *Cal. Pharmacists Ass'n v. Maxwell-Jolly*, 563 F.3d 847 (9th Cir. Cal. 2009).

The SEC claims Appellants failed to raise this issue until their reply brief with the district court. While true, Hebrank first reported his pooling of assets in his Revised 14th Interim Report, filed just four days before Appellants' stay motion. D. 1315. Further, the district court denied Appellants' motion for and accounting, which addressed in detail the need for Hebrank to record transactions. D. 1258-1 at 16-20 and 1299 at 10-13.

V. Appellants Will Likely Succeed on the Merits

A. The District Court Lacked Subject Matter Jurisdiction over the GPs

Relying on *In Re San Vicente Med. Partners, Ltd.*, 962 F.2d 1402 (9th Cir. 1992), both the SEC and Hebrank contend the district court has subject matter jurisdiction over 87 GPs, because Western controlled the GPs as *de facto* limited partnerships. The theory has multiple flaws which neither party addresses. First, both confuse the issue whether Western controlled the GPs *when Hebrank was appointed*—the relevant issue for subject matter jurisdiction—with the issue whether Hebrank controlled the GPs when they were sold to investors, the relevant issue for deciding whether the GP interests were securities. Second, both are dead wrong in claiming Appellants must overcome the district court's broad discretion when it decides its own jurisdiction. DE 13 at 9 and 15 at 17. Both ignore the decisions of this Court, cited in Appellants' opening brief, which hold (1) the party alleging subject matter jurisdiction—the SEC—has the burden of proof and (2) this Court reviews the issue *de novo*. DE 12 at 16.

The district court never addressed whether Western had control of the GPs in the context of its subject matter jurisdiction, because the parties stipulated to it. D. 174. The issue did arise three times in the context whether the GPs were securities. Each time, the district court expressly or impliedly held Western lacked control of the GPs *at the time Hebrank was appointed*. In each case, the district court decided whether the GP agreements fit the first factor of *Williamson v. Tucker*, 645 F.2d 404 (5th Cir. 1981): does the "agreement among the parties leave so little power in the hands of the partner or venturer that the arrangement in fact distributes power as would a limited partnership."*Id.,* at 424.

The district court first addressed the issue when it ruled on the SEC's application for a preliminary injunction, holding the SEC's argument "missed the mark." D. 44 at 7. The case was then transferred from Judge Burns to Judge Curiel.

The issue arose twice more. When defendants moved to dismiss the complaint, the district court again concluded:

> [T]he SEC's claims do not meet the first *Williamson* factor because the SEC does not sufficiently allege the GP agreements "leave so little power in the hands of the partners' as to render the GPs limited partnerships."

D. 212 at 6. The issue arose for a third time when the district court ruled on the SEC's motion for a summary judgment. This time the district court held Western *had control* of the GPs when the GP interests were sold to investors, but that control passed to investors when the partnership agreements became operative. In the district court's words: "The focus under *Williamson* is on the investor's expectations at the *time of the original investment*, and is not directed at what actually transpires after the investment (emphasis added)." D. 583 at 15. "Investors did not control these bank accounts until the Partnership Agreements, which provided for the appointment of signatory partners, became effective." *Id*. at 6.

The SEC correctly argues the transfer of control did not happen for months or sometimes years after Western sold the GP interests to investors. But this fact does not support their argument. Hebrank's June 20, 2013, report states that all partnerships had closed and the properties had been transferred to the GPs before 2012 (D. 203 at 3-8), except for the Stead property. *Id*., at 6. Since investors controlled all GPs when Hebrank was appointed, except three Stead GPs, the district court lacked subject matter jurisdiction over 84 GPs.

Finally, the SEC argues the district court's decision "established the GP investors were dependent on defendants' managerial control for the success of the enterprise." DE 13 at 11. This argument is twice flawed. First, the SEC is confusing the issue whether Western controls the GPs with the issue whether the GP interests were securities when they were sold. Only the first *Williamson* factor focuses on the issue of control and, as discussed above, the control on 87 GPs passed from Western to investors by the time the receiver was appointed. Second, the dependency on management falls within the third *Williamson* factor. See *Koch v. Hankins*, 928 F.2d 1471, 1476 (9th Cir. 1991). The district court did not base its decision on this factor. To the contrary, its holding was very specific: "The SEC's MSJ, (ECF No. 563), is GRANTED with respect to the first Williamson factor and DENIED as to the second and third Williamson factors." D. 583 at 20.

Finally, the issue of subject matter jurisdiction is reviewed by this Court *de novo*. *SEC v. Am. Capital Invs*. 98 F.3d 1133, 1142 (9th Cir. 1996). Appellants' opening brief noted the district court had briefly summarized *some of* investors' powers under the GP agreements. D. 44 at 9-10 and DE 12 at 8-9. That was not *dicta*. The district court described some of the terms of the GP agreement which

Appellants offered as evidence in the opening brief. DE 12 at 20. See also D. 1293-3, Ex. 10, pp. 42-69.

B. The District Court Committed Reversible Error by Denying Investors' Motion to Intervene

Again, the SEC opposes the motion to intervene, but Hebrank does not. The SEC does not challenge the fact Hebrank made a stunning reversal by filing his proposed liquidation plan on February 4, 2016. D. 1181. He had never at any time in the past proposed pooling. On the orderly sale, the district court found:

> [T]o the extent that Investors seek to oppose the Receiver's orderly sale motion regarding its proposal for the disposition of receivership assets, the Court finds such an intervention timely. The Receiver did not move for authorization to conduct an orderly sale of the GP properties until February 4, 2016.

D. 1296 at 7. As discussed in our opening brief, it was the change in position—Hebrank's proposed pooling and orderly sale—as the district court stated above that triggered the need for Appellants to intervene. Appellants first address the SEC's mischaracterization of what they sought through their intervention. It was presented to the district court as follows:

> Our focus is surgical. Investors [limit]…their proposed intervention to post judgment issues along these lines:
>
> 1. Proposing a plan allowing the GPs to exit the receivership;
> 2. Seeking an order that the GP agreements remain in effect;
> 3. Proposing options to sell the properties, including 28 USC § 2001;
> 4. Proposed plan of distribution for GPs which remain in the receivership; and
> 5. An accounting of the receivership.
>
> The first four subjects are tightly interwoven…

D. 1274 at 8. Each is a key steps for Appellants to propose an alternate plan for investors to vote on. The district court's ruling sheds light on Appellants' proposals. It ordered Hebrank to comply with 28 USC § 2001. D. 1304 at 31. It also ordered him to comply with SFAR since he had failed to do so in any of his 14 reports to the district court. *Id.*, at 32.

The SEC relies on the district court's statement Appellants should have intervened after the district court's order of March 3, 2015 (D. 1003), because the district court reversed its earlier order and kept the GPs in the receivership. Appellants submit any competent attorney studying this order would have concluded it unwise to intervene in the case before a final judgment was entered. Appellants' motion to intervene sought an order allowing the GPs to exit the receivership. The district court expressly held it was premature to obtain an order seeking the release of the GPs *until the conclusion of the case*:

> The Court finds that, consistent with "the public interest in maintaining the receivership estate's assets while the SEC pursues charges against the Defendants," the most equitable decision is to keep all the GPs within the receivership *until the conclusion of this case* (citations omitted).

D. 1003 at 18-19. The district court went onto explain over why the GPs would not be allowed to exit the receivership until the case was concluded. *Id*. at 18-20.

Contrary to the SEC’s suggestion, Appellants did not merely claim Hebrank failed to submit reports in a certain form. No meaningful reports existed. There was no clue where the money came from, where it went or why (D. 1258 and

1299) until the district court directed Hebrank to comply with SFAR from the last quarter of 2015 going forward. D. 1304 at 32. No one raised that issue except Appellants. Hebrank did not need an accurate accounting, because his plan did not require a vote. His plan boiled down to this: sell the assets, throw money into a "single pot," and split it up *pro rata*. No plan can be proposed for an investor vote unless it states the assets, liabilities and cash flow. How can investors vote on any plan if they do not know how much it will cost or whether there are funds to pay for it? Every partner in every GP has the right to access the books of account. D. 1293-3 at 47, 2.6. Hence, Appellants' request access to the financial records (D. 1258) or an accounting (*Id*.) was merely the exercise of the right they already possessed and one they had to exercise to make an alternative proposal. Other courts have denied a plan solely on the grounds the receiver failed to provide a detailed accounting. *SEC v. Harris*, 2015 U.S. Dist. LEXIS 11975 (N.D. Tex. 2015).

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Respectfully submitted,

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