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UNITED STATES DISTRICT COURT

NORTHERN DISTRICT OF CALIFORNIA

SAN FRANCISCO DIVISION

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

vs.

JOHN V. BIVONA; SADDLE RIVER ADVISORS, LLC; SRA MANAGEMENT LLC; FRANK GREGORY MAZZOLA,

Defendants, and

SRA I LLC; SRA II LLC; SRA III LLC; FELIX INVESTMENTS, LLC; MICHELE J. MAZZOLA; ANNE BIVONA; CLEAR SAILING GROUP IV LLC; CLEAR SAILING GROUP V LLC,

Relief Defendants.

Case No: 3:16-cv-01386-EMC

THE SRA FUNDS INVESTOR GROUP'S SUPPLEMENTAL BRIEF IN RESPONSE TO THE COURT'S JULY 17, 2018 ORDER [DKT. 379]

Prior Hearing Date: July 16, 2018
Time: 1:30 PM
Courtroom: 5
Judge: Hon. Edward M. Chen

The SRA Funds Investor Group (the "Investor Group") respectfully submits this brief in response to the Court's Order of July l7, 2018 (Dkt. 379, for supplemental briefing on the motions by interested parties Progresso Ventures, LLC ("Progresso") and Global Generation Group, LLC ("Global") for a determination of their clamant status. As relevant to those motions, the Court requested that the parties brief three questions: (1) whether the Court may adjust the priority of a money judgment (or portions thereof such as principal versus interest) relative to investor claims to a distribution; (2) whether the Court may ignore or discount any portion of a money judgment to permit recovery, e.g., of only the original out-of-pocket loan/investment (as under the SEC's proposed plan); and (3) whether Progresso and Global can be permitted to "choose" between investor or creditor status, or must be treated as creditors based on their money judgments. Dkt. 379.

For the reasons set forth below, there is clear authority permitting the Court to adjust the priority of a money judgment in an SEC receivership action, and to discount any portion of such a judgment, as an adjunct to the Court's authority to approve a "fair and reasonable" distribution plan. There is no legal authority that would allow Progresso and Global to "choose" their claimant status, however. As a factual matter, the Court cannot fairly and reasonably distribute receivership proceeds to Progresso or Global as "investors" without doing grave harm to other investor victims of the fraud.

I. Progresso and Global Do Not Enjoy "Priority" as Money Creditors

Federal district courts have discretion to classify claims sensibly in SEC receivership proceedings. "It is widely acknowledged that the district court has "'broad powers and wide discretion' "in crafting "relief in an equity receivership proceeding." *SEC v. Basic Energy & Affiliated Resources, Inc.*, 273 F.3d 657, 668 (6th Cir.2001), quoting *SEC v. Elliott*, 953 F.2d 1560, 1566 (11th Cir.1992). The Court's "'broad powers and wide discretion' extend to allocating the priority of distributions from the receivership estate." *Quilling v. Trade Partners, Inc.*, 2007 WL 107669, at *2 (W.D. Mich. 2007) (internal citation omitted) ("*Quilling II*"). Thus, in receivership proceedings, unlike in bankruptcy proceedings,[1] money judgment creditors are ***not afforded priority***

[1] There is nothing that requires the SEC to follow the Bankruptcy Code's claim priorities when developing a distribution plan. *Official Comm. of Unsecured Creditors of WorldCom Inc. v. SEC*, 467 F.3d 73, 84 (2d Cir. 2006) ("*WorldCom*"); *SEC v. Cobalt Multifamily Investor I, LLC*, 2009 WL 1808980, at *4 (S.D.N.Y. 2009).

in receivership proceedings arising out of securities fraud. In fact, in several cases, the interests of defrauded investors take priority over the claims of judgment creditors.

For example, federal district courts in Michigan (where Global obtained its judgment) have held that "[a]s an equitable matter in receivership proceedings arising out of a security fraud, ***the class of fraud victims takes priority*** over the class of general creditors with respect to proceeds traceable to the fraud." *Quilling v. Trade Partners, Inc*., 2006 WL 3694629, at *1 (W.D. Mich. 2006) ("*Quilling I*") (emphasis added). At best for Global, federal district courts in Michigan, sitting as courts of equity in receivership proceedings, have discretion to treat all defrauded victims equally – with no one class of victims being afforded priority over others. *Id*., at *1-2.

Federal courts overseeing receiverships in New York (where Progresso obtained its judgment) also do not give priority to money judgment creditors in determining plans of distribution. In *Rafkind v. Chase Manhattan Bank, N.*A., 1992 WL 380291, at *2 (S.D.N.Y. 1992), for example, judgment lien holders were denied priority to monetary assets collected and held at Chase bank for the benefit of all persons who had sustained losses arising out of securities fraud. The court held:

> New York Courts do not give one victim of a fraud priority over other victims of fraud even if none of the victims of the fraud has obtained a judgment. …Here, the Rafkinds have a judgment that is predicated on the same fraud that victimized the other possible claims to the disgorgement fund. As a matter of equity, they should not be given priority of their fellow victims. *Id.*

Similarly, in *U.S. v. Benitez*, 779 F.2d 135, 139 (2d Cir. 1985), the Second Circuit affirmed a district court order declining to give a judgment creditor priority to monies held for victims of a confidence scheme. The court relied, in part, on the Restatement (Second) of Restitution, §43, comment b, entitled "Creditors rights in general" which provides: "In controversies over the distribution of a debtor's assets, a constructive trust or an equitable lien" – as exists in SEC receiverships – "is prior in right to the claims of [its] creditors." *Id*. at 140. *Benitez* also looked to New York law, as recited in *Stuhler v. State of New York*, 485 N.Y.S. 2d 957, 960, *aff'd mem*., 493 N.Y.S. 2d 70 (App. Div. 1985), that judgment creditors are not entitled to priority over other fraud victims "because to do so would be inequitable to the other claimants." *Id.* Thus, whether applying New York state or federal law, the result is the same: no victim of fraud has a priority over other

victims of the fraud. Money judgment creditors, therefore, are not entitled to priority over defrauded investors. *C.F.T.C. v. Efrosman*, 2009 WL 2958389, at *8 (S.D.N.Y. 2009).

That Global and Progresso expended money and time to obtain their judgments has no bearing on the Court's question. *Efrosman*, 2009 WL 2958389, at *8. Courts faced with similar arguments have declined to afford preference. "It would be unjust to give preference to judgment creditors," these courts hold, because doing so would encourage creditors to file secondary litigation in the hope of "jumping the line" in the event of a distribution, while defrauded investors reasonably chose not to seek such judgments knowing they would not be collectible. *SEC v. Gruttadauria*, 2009 WL 10689855, at *2-3 (N.D. Ohio 2009) (finding SEC's decision not to give preference to money creditors in proposed distribution plan was both fair and reasonable).

II. The Court May Decline or Reduce Distributions to Progresso and Global

Because this is an SEC receivership, the Progresso and Global money judgments are not binding on the Receiver, which itself has no authority to allow claims or distribute assets. Nor are these judgments binding on the Court. *SEC. v. Management Solutions, Inc*., 2013 WL 594738, at *2, *3 (D. Utah 2013) ("district court supervising a receivership may deny equitable remedies that might otherwise have been made available to a creditor"). Instead, in exercising its "broad powers and wide discretion," the Court, alone, must determine the appropriate relief to be afforded in the receivership. *SEC v. Lincoln Thrift Ass'n*, 577 F.2d 600, 606 (9th Cir. 1978); *accord WorldCom*, 467 F.3d at 81.

The ultimate decision to make distributions – in what amount and to whom – therefore, rests entirely with the Court. *SEC v. Credit Bancorp, Ltd*., 290 F.3d 80, 87 (2d Cir. 2002). In making that decision, as Global acknowledged in its motion (Dkt. 359), there may be the "kind of line-drawing [that] inevitably leaves out some potential claimants." *SEC v. J.P. Morgan Securities, LLC*, 266 F. Supp. 3d, 225, 229 (D.D.C. 2017). "[R]emedies to which claimants might be entitled under other law may be suspended if such a measure is consistent with treating all claimants fairly." *SEC v. Credit Bancorp, Ltd.*, 2000 WL 1752979, at *28 (S.D.N.Y. 2000). "Nearly every plan to distribute funds obtained in an [SEC] enforcement action requires choices to be made regarding the allocation of funds between and among potential claimants within the parameters of the amounts recovered." *J.P.*

Morgan Securities, 266 F. Supp. at 229, quoting *SEC v. CR Intrinsic Investors LLC*, 164 F. Supp. 3d 533, 534 (S.D.N.Y. 2016). "'There are no hard rules governing a district court's decisions in matters like these. The standard is whether a distribution is equitable and fair in the eyes of a reasonable judge.'" *SEC v. Byers*, 637 F. Supp. 2d. 166, 174 (S.D.N.Y. 2009) *aff'd sub nom*. *SEC v. Orgel*, 407 Fed. Appx. 504 (2d Cir. 2010) (internal citation omitted).

Courts have declined to give full effect to money judgments in other cases. In *WorldCom*, the Second Circuit affirmed the district court's approval of a distribution plan that excluded certain creditors from recovering anything from the receivership, limiting their relief to amounts previously recovered on their judgments, noting "[w]hen fund are limited, hard choices must be made." 467 F.3d at 84. In *Byers*, the court only permitted secured creditors to recover out of their collateral, prohibiting them from receiving distributions under the receiver's plan, and finding it inequitable to permit the secured creditors to recover more than injured investors. In *SEC v. Amerindo Investment Advisors, Inc*., 2017 WL 3017504, at *1, *2 (S.D.N.Y. 2017), the court approved a distribution plan that paid principal only to defrauded claimants in initial plan distributions.

Here, the Court may properly exercise its wide discretion and equitable "line-drawing" to exclude recoveries to Progresso and Global, or limit their recoveries to amounts that allow for "fair and reasonable" distributions to defrauded SRA Funds investors. Progresso's claim is particularly problematic. The judgment upon which it seeks a recovery is against FB Management Associates, LLC – an entity that is neither a defendant, a relief defendant, nor an affiliated entity within the SEC Receivership. The basis for Progresso's claim is tracing, a disfavored practice in SEC proceedings generally. *See SEC v. Elliot*, 953 F.2d at 1569. If Progresso's tracing claim is permitted, the most equitable resolution, and the course that treats all victims of the fraud equally, is for the Court to limit Progresso's distribution from the Receivership to the $1.5 million unpaid balance that is owed to it under the Note. Progresso is free to continue to attempt to enforce its judgment and seek additional funds from FB Management outside of the Receivership.

For similar reasons, the Court should exercise its equitable discretion and limit any distribution to Global from the Receivership to $1.7 million. This is the amount it was awarded in arbitration, and represents the unpaid balance of funds owed to Global) after it exercised its put

option for the return of monies invested in Palantir.

III. Progresso and Global are Creditors And Cannot "Choose" to be Investors

Progresso and Global are not free to choose to be investors for purposes of this Receivership proceeding. Both entities have already chosen to be judgment creditors, by electing to litigate their claims to final money judgments in New York state court and Michigan federal court, respectively. Neither of these judgment was appealed. Thus, as argued by the Investor Group in its prior opposition (Dkt. 362), Progresso and Global are confined to their judgment creditor status by principles of res judicata, claim preclusion, and claim splitting, and are bound by their election of money judgment remedies having purposefully not availed themselves of any potentially available investor remedies.

In addition, there is a practical hurdle to being reclassified as "investors" that Progresso and Global cannot scale here. To be cognizable in receivership, claims must be certain or "capable of being made certain by recognized methods of computation." *First Empire Bank–New York v. FDIC*, 572 F.2d 1361, 1369 (9th Cir. 1978) (quoting *Pennsylvania Steel Co. v. New York City Ry. Co*., 198 F. 721, 738 (2d Cir. 1912)), *cert. denied*, 439 U.S. 919, 99 S.Ct. 293, 58 L.Ed.2d 265 (1978).

Here, it is not possible to calculate Progresso's or Global's monetary claims in Palantir shares with reasonable certainty. Progresso never itself invested in Palantir, and there are no records (whether maintained by SRA, the SEC or the Receiver) that would enable the Court to figure out a theoretical price at which any such shares could be deemed to have been "purchased," as a means of discerning the amount of any "return" that may be available to Progresso, in distributions, when there is a liquidity event. Global, in turn, has already indicated its desire ***not*** to hold any Palantir shares even at its initial purchase price of $3.00/share. Having clearly expressed its wishes that it ***not*** be deemed a Palantir investor, even that low share price, how can the Court equitably decide what return may be available to Global in a receivership distribution, and at what share price?

The other complicating factor is that SRA Fund investors have all agreed to net out of any share distributions amounts that have been reserved for management fees and back-end fees (carried interest). The amount of these management fees and back-end fees may vary by investor, but every investor at least has a subscription agreement and welcome letter that determines how it is to be calculated. If they are to be treated as investors, to avoid benefitting them over others, Progresso and

Global must net out from any "investor" distribution appropriate management fees and back-end fees. But, without a subscription agreement and welcome letter, there is no ready means to know what these fees would be or from what point they should be calculated. These uncertainties make an "investor" recovery for Progresso or Global incalculable. Equity requires that they be treated solely as creditors for distribution purposes.

IV. Conclusion

The Court has wide discretion to adjust the priority and discount the amounts of Progresso and Global's money judgments in approving a "fair and reasonable" receivership distribution plan that puts all victims on equal footing. Any distribution from the SEC Receivership allowed for Progresso should be limited to roughly $1.5 million in cash, and any distribution allowed for Global Generation should be limited to approximately $1.7 million in cash. Neither entity should be treated as an SRA Funds investor for receivership distribution purposes. Any distribution from the Receivership that is approved for Progresso or Global should be paid out only when there is a liquidity event that generates sufficient amounts to fund distributions to judgment creditors and SRA investors alike, at the same time and on an equitable basis.

Respectfully submitted,

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