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UNITED STATES DISTRICT COURT

NORTHERN DISTRICT OF CALIFORNIA

SAN FRANCISCO DIVISION

SECURITIES AND EXCHANGE COMMISSION, Plaintiff, v. JOHN V. BIVONA, et al., Defendants and Relief Defendants.	Case No. 3:16-cv-01386-EMC **PLAINTIFF SECURITIES AND EXCHANGE COMMISSION'S OPPOSITION TO PROVISIONS IN RECEIVER'S REVISED DISTRIBUTION PLAN** Date: April 7, 2020 Time: 10:30 a.m. Courtroom: 5 Judge: Edward M. Chen

I. Introduction

Plaintiff Securities and Exchange Commission ("Commission" or "SEC") opposes certain provisions of the Receiver's Revised Distribution Plan ("Revised Plan" or "Plan") (ECF 570-1, Exhibit A). The SEC routinely advocates certain basic receivership principles in numerous court-appointed receiverships and distribution plans. One such principle is that all defrauded investors should have a fair and equitable opportunity to participate in a distribution plan. By excluding – due to the Court's prior orders – any recovery for investors with "Failed Investments," the Revised Plan leaves some defrauded investors without any recovery from the receivership, while significantly reducing the recovery of other investors. The SEC therefore states again its views on the necessary components of an equitable, court-approved distribution plan.

II. Legal Argument

A. Defendants Commingled Failed Investment Proceeds As Part of Their Fraud.

The SEC has demonstrated that defendants operated a fraudulent scheme whereby defendants diverted investor money to purchase shares in other pre-IPO companies and misappropriated investor money for their personal use. ECF 4 to 20 (Plaintiff's Motion for TRO and Preliminary Injunction); ECF 197 to 201 (Plaintiff's Motion for Approval of Joint Distribution Plan). Defendants' fraud included using proceeds from Failed Investment companies such as Practice Fusion to help purchase shares of successful companies such as Palantir and Flurry. ECF 14 at pgs. 29-31 (Ellen Chen Declaration, Figure 15a). Similarly, during the last quarter of 2013, SRA Fund I received investor money intended for shares in Failed Investments such as Jawbone and Practice Fusion, as well as to acquire shares for a variety of failed and successful companies in the Big Ten Fund. SRA Fund I diverted the investor money to defendants and other related entities. Some of the diverted money was then used for other investments, such as in Palantir. ECF 200 at pgs. 18-22 (Monica Ip, CPA Expert Declaration). *See also* ECF 14 at pgs. 26-27 (describing diversion in March 2014 of some Failed Investment Practice Fusion and Jawbone investor money to Michele Mazzola) (Ellen Chen Declaration, Figure 12).

In its Order Regarding Plaintiff SEC and Receiver's Request for Preliminary Findings, dated September 13, 2017 ("Preliminary Findings Order"), this Court determined that "Defendants

generally engaged in commingling of funds affecting the investors" and that "the shares Defendants purchased on behalf of their investors were pooled in common holding companies." ECF 246 at 16. Additionally, "the shares purchased by Defendants were also pooled together, complicating any effort to meaningfully segregate or identify which shares were owned by which investor at any given time." *Id.* at 18. The Court therefore rejected the tracing of shares to particular investors, without having to decide whether defendants acted fraudulently. *Id.* at 15.

B. Excluding Recovery For Failed Investments Is Contrary To Case Law and Equity.

In cases involving multiple victims and commingled funds, the equities require that "all victims of the fraud be treated equally." *United States v. Real Property Located at 13328 and 13324 State Highway 75 North*, 89 F.3d 551, 553-54 (9th Cir. 1996) (citing *Cunningham v. Brown*, 265 U.S. 1, 12-13 (1924)) (approving plan to have all investors recover from sale of real property that was purchased with money from a particular investor). *See SEC v. Sunwest Management, Inc.*, 2009 U.S. Dist. LEXIS 93181 at *34 (D. Or. Oct. 2, 2009) (authorizing consolidated *pro rata* investor recoveries from a pool of real estate holdings). In particular, courts use a consolidated pool of assets to repay investors in Ponzi-scheme frauds. *See SEC. v. Byers*, 637 F. Supp. 2d 166, 177 (S.D.N.Y. 2009) (stating that consolidated distribution is appropriate where earlier investors might have received benefit from later investors' money) (citing *SEC v. Credit Bancorp, Ltd.*, 290 F.3d 80, 89 (2d Cir. 2002)).

On December 20, 2018, the Court entered its Order Re Proposed Distribution Plans (ECF 443). In that Order, the Court declined to extend any recovery for investors in pre-IPO companies that had failed due to business reasons unrelated to defendants' fraud. ECF 443 at 9-10. The Court also decided that rather than distributing money to investors, the distribution would be in shares. *Id.* at 10. The Court did not terminate the receivership, however, so that the Court could continue to exercise supervision. *Id.* at 11. On February 19, 2019, the SEC submitted a revised plan in accordance with the December 20, 2018 order. ECF 456. The SEC reserved its objections to components of the revised plan. *Id.*

That earlier revised plan contained an SEC proposal to provide a recovery to investors with Failed Investments in the event that there were funds left over after the payment of unsecured claims.

Id. at 16. Following a hearing on the revised plan, the Court issued an Order excluding any recovery for investors with Failed Investments. ECF 470 at 2.

Viewing these Orders as binding upon her, the receiver filed a motion on May 23, 2019 to exclude investor claims for Failed Investments. ECF 481 and 481-1, Exhibit 4, at pgs. 19-27. The total, current, gross amounts of the Failed Investments in the Felix Multi-Opportunity Funds, NYPA Funds and SRA Funds investors is $18.883 million, or about 28% of the total equity investment amount. *See* ECF 481-1, Exhibit 4, at pgs. 19-27. The total value of Failed Investments where the claimant does not have other successful or active investments is $662,659.

The amount of Failed Investments could increase. The current Revised Plan defines a "Failed Investment" to include any pre-IPO company that did not have an initial public offering or liquidity event, and has failed. ECF 570-1 at pg. 12. This definition of "Failed Investment" includes current pre-IPO companies that fail in the future without going public or having a liquidity event. *Id.* As a result, the Revised Plan could eventually exclude even more than $18.883 million in Failed Investments from recovery.

C. Two Other Provisions Are Inequitable to Certain Investors.

By excluding claimants with Failed Investments, the Revised Plan contains two additional provisions that become inequitable in character. First, the Revised Plan grants Class 5 subordinated claims totaling $1 million to two investors – Kenneth Lacey and Alex Pisemsky – in now worthless Badgeville Corporation shares that were purchased through an off-shore entity, the Silverback Funds. ECF 570-1 at 21. These two Silverback Fund investors purchased their Badgeville shares from Carsten Klein, who guaranteed the investors the complete recovery of their principal investments, plus a 50% profit. Additionally, the Revised Plan provides Carsten Klein with a subordinated Class 5 claim for $100,000 in commissions for selling Palantir shares through Saddle River Advisors. Carsten Klein is a former Saddle River insider who helped defendant Frank Mazzola set up an off-shore entity to sell securities to investors. It is inequitable, on its face, to give $1.1 million in subordinated claims to Carsten Klein and his clients, while denying any recovery for defrauded investors holding Failed Investments. The Lacey and Pisemsky subordinated claims are particularly unfair because they hold Failed Investments in Badgeville, but can recover due to their guarantee

claims against Carsten Klein.[1]

Second, the Revised Plan creates a tax fund to cover the receivership's tax liabilities for selling and distributing shares. Investors with successful investment must contribute the necessary amount to the tax fund to cover those liabilities. The SEC understands that tax losses associated with several of the Failed Investments will be used to off-set, or even eliminate, the tax liabilities associated with the successful investments. Although using those Failed Investments' tax losses provides a potentially significant economic benefit for investors with successful investments, the receivership is not allowed to provide any compensation to any of the investors holding Failed Investments. The use of such tax losses generated by the Failed Investment highlights a Revised Plan inequity; the SEC believes that the receivership should benefit all defrauded investors, not only investors in successful companies.

D. There Should Be A Recovery Fund For The Failed Investments.

The Revised Distribution Plan is inequitable so long as no mechanism exists to provide compensation to claimants for Failed Investments. A recovery fund can be created for Failed Investments with three potential sources of funding. First, the gross investment amount of the three companies – Jawbone, Candi Controls and Practice Fusion – that failed after the receivership began totals about $9.55 million. If tax losses associated with those Failed Investments provide an actual tax reduction for claimants in successful companies, then the dollar amount of the actual tax savings should be placed in the recovery fund. Second, if the Plan Fund has a remaining balance after payment of all priority administrative claims and unsecured claims, then the receiver should request that a substantial portion of the remaining balance be transferred to the recovery fund. Third, the SEC's staff is open, with the necessary approvals, to filing a motion to transfer money from the disgorgement fund to the recovery fund for distribution to investors with Failed Investments. Once the recovery fund is financed, the proceeds can be disbursed in an appropriate pro rata fashion to

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[1] The $1.1 million subordinated claim was negotiated as part of a share exchange with Klein's company, Equity Acquisition Company ("EAC"). The primary purpose of the share exchange was to obtain about 317,000 Palantir shares that EAC was holding, but that the receivership actually paid for. Because the Court ordered the distribution of shares, acquiring the 317,000 Palantir shares benefited only Palantir investors, who would have otherwise faced a larger share shortfall, rather than benefitting the receivership as a whole.

claimants with Failed Investments. That disbursement should take into account the claimant's recovery through the receivership for successful investments.

III. Conclusion

For the reasons set forth above, the SEC respectfully states its objections to the Revised Plan and opposes the Court's adoption of the Revised Plan.

DATED: March 13, 2020

Respectfully submitted,

/s/ John S. Yun
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SECURITIES AND EXCHANGE COMMISSION