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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 RESPONSE TO THE RECEIVER'S SUPPLEMENTAL FILING RE PROPOSED DISTRIBUTION PLAN (ECF NO. 538)

Date: January 30, 2020
Time: 10:30 AM
Courtroom: 5
Judge: Hon. Edward M. Chen

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INTRODUCTION

The SRA Funds Investor Group ("Investor Group"), having consulted with tax expert Scott C. Burack, respectfully submits this response to the Receiver's December 16, 2019 supplemental filing (the "December 16 filing") (ECF No. 538) regarding the proposed distribution plan in this matter. That filing raises more questions than it answers and creates new issues instead of resolving existing ones.

Tellingly, despite the passage of many months and significant expense to investors[1], the December 16 filing does not contain the key information that the Court identified as critical in June 2019: specifically what are the tax and cost implications to investors and creditors if the Receiver's proposal to sell shares to generate some $13.5 million for a Plan and Tax Fund is approved by the Court? And, how do those implications compare, on a cost basis, to the steps that must be taken to implement the fair and equitable distribution plan proposed by the Investor Group that the Court has said must be followed by Receiver to the extent possible? These core questions remain unanswered.

The Receiver appears to lay blame at the feet of the Investor Group for her singular conclusion that a qualified settlement fund ("QSF") over the receivership estate emerged as a matter of law when the receivership was established by the Court's October 11, 2016 order ("Receivership Order") (ECF No. 142). Any such attack on the Investor Group by the Receiver, of course, is misdirected. More critically, however, the legal conclusion the Receiver reaches is by no means settled. There are many reasons for the Court to conclude that no QSF was created, here, since ***no*** QSF elections, statements or tax returns have ever been filed by any Receiver as required by IRS regulations that govern QSFs.[2] To the extent a QSF was created, it appears to extend only to "cash

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[1] Based on current filings, the two Receivers appointed in this matter (and their counsel) have expended about $1.5 million in professional fees and expenses thus far.

[2] *See* ECF No. 538 at p. 25, acknowledging that neither the present Receiver nor her predecessor ever filed a QSF election, statement or tax return.

or cash equivalents" held in a Receiver-controlled federally-insured bank account (*see* ECF No. 142 at p. 11), and there has been no action to date by any Receiver to physically separate and transfer any securities to a QSF – a critical prerequisite for a QSF under Treas. Reg. § 1.468B-1(c)(3).

Similarly, there is no language in the Receivership Order that dictates that non-cash or non-cash equivalent assets, such as the securities at issue here, were intended to be placed into a QSF. On the contrary, the Receivership Order separately and specifically gives the Receiver control over Clear Sailing, the entity that holds the securities at issue, and in this way provides authority to the Receiver to manage and file statements and tax returns for that entity and those securities, separate and apart from any QSF (assuming one was created here). *See* ECF No. 142 at p. 1-3.[3]

The Receiver's claim that the Investor Group's plan would be more expensive and take longer to implement than her proposed plan is based on speculation, unsupported by any facts or experience since this is the Receiver's first receivership appointment. The Receiver has provided no estimates of the relative costs and expenses of any of the plans and has no idea what the actual costs of her plan may be – all the while acknowledging that her plan would require hiring a valuation expert and impose an extraordinarily high tax rate (43%) on any gains in the underlying securities that constitute all of the assets of this receivership estate. The Receiver does not know whether her proposed distribution plan would be less, rather than more expensive, than another plan. Similarly, the Receiver's suggestion that her plan will be implemented more quickly is again unknowable by her and undermined by the admission that all of the plans depend on the same underlying liquidity events. No plan can be implemented more quickly than another here.

The December 19 filing and the Receiver's suggested plan is most notable for its utter failure to set forth how either investors or creditors are benefitted by what the Receiver proposes to do without support from either group. As for investors, in addition to the 43% tax rate they would have to bear on any gains (as opposed to the much lower long-term capital gains rate), they also

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[3] To the Investor Group's knowledge, no Receiver has prepared or filed statements or tax returns for Clear Sailing either.

would be responsible for any taxes that would have been due as of the date of the receivership's creation in October 2016 (if one adopts the view that a QSF also was created at that time), together with any interest and IRS penalties that would have accrued on that tax liability since that date. These and other substantial impacts to investors need to be quantified and fully considered as part of any proposed distribution plan here.

For all of the reasons set forth below, the Court should (i) order the Receiver to implement a distribution plan that incorporates the key elements of the Investor Group's plan that the Court previously indicated it would adopt, (ii) reject most of the Receiver's latest round of changes to her distribution plan, (iii) instruct the Receiver **not** to file qualified settlement fund ("QSF") tax returns at this time, and (iv) deny the Receiver's request to retain a valuation firm.

RESPONSE RE TAX ISSUES

The Receiver asserts she cannot implement the Investor Group's portion of the plan without significant tax implications because a QSF was created over the entire receivership estate on October 11, 2016, when the Receivership Order was entered. But, this is not supported by the record for three reasons.

First, it is not clear that any QSF was created by the Receivership Order on October 11, 2016, because the creation of a QSF required more than simply the entry of an order: it also required that the Receiver "take all necessary steps to enable the Receivership Funds to obtain and maintain the status of a taxable 'Settlement Fund,' within the meaning of Section 468B of the Internal Revenue Code and of the regulations, when applicable whether proposed, temporary or final, or pronouncements thereunder, including the filing of the elections and statements contemplated by those provisions." ECF No. 142 at p. 11. Here, there is no record that the Receiver ever took ***any*** of the necessary prerequisites to obtain and maintain the status of a QSF under the Internal Revenue Code, ever filed "elections and statements" for a QSF, or ever filed QSF tax returns. Indeed, the

Receiver acknowledges that, to date, no tax returns and other required information have ever been filed on behalf of a QSF.[4]

Second, and relatedly, at least with respect the securities and forward purchase contracts, the Receiver is not able to satisfy the third prong of the QSF test set forth in Treas. Reg. 1.468B-1, and discussed in Chief Counsel comment at CCA 200113045. This prong requires that assets in the fund, account, or trust be physically segregated from other assets of transferor. But, here, the securities either remain unsegregated in accounts at Clear Sailing or are outstanding pursuant to forward purchase contracts. They have never been physically segregated and placed in the fund that the Receivership Order contemplates as the QSF.

Third, if a QSF was created at all on October 11, 2016, it was not over the entire receivership estate, as the Receiver contends, just certain enumerated receivership funds. The relevant language in the Receivership Order pertaining to the QSF refers to "Receivership Funds," not the "Receivership Estate," "Receivership Entities," or "Receivership Assets." *See* ECF No. 142 at p. 11. "Receivership Funds" is a defined term in the Receivership Order and means "cash equivalent Receivership Property" that is to be maintained by the Receiver in "one or more custodial accounts at a federally insured bank." *Id.* at p. 10. The Receiver's attempt to conflate the entire receivership estate with the QSF is contrary to the plain language in the Receivership Order. The securities held at Clear Sailing and the forward purchase contracts still outstanding are not "cash equivalent Receivership Property" and not held in "custodial accounts at a federally insured bank."

The Receiver relies almost entirely on one case, *United States v. Brown*, 348 F.3d 1200 (10th Cir. 2003) in support of her tax argument. The Receiver's reliance on *Brown* is misplaced for several reasons. First, unlike in *Brown*, here there is a real question as to whether any QSF even

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[4] The Receiver seeks to remedy this deficiency and essentially force the adoption of her plan by requesting authorization from the Court to file QSF tax returns now. *See* ECF No. 538 at pp. 4, 25. The Court should decline this request and instruct the Receiver to only file tax returns once it has been established definitively whether any QSF has been created and what Receivership Funds are included in the QSF.

has been created since the Receiver has not taken any of the steps required by the Receivership Order or Internal Revenue Service regulations to create a QSF. Second, even if a QSF has been created, under the plain terms of the Receivership Order, the QSF would only include cash and cash-equivalents held in a federally insured bank account and exclude securities separately held in different accounts at Clear Sailing. Third, *Brown* addresses a scenario where a receivership is created not to restore shares to investors, but to liquidate and refund the purchase price of such securities. The Tenth Circuit suggests it may well have reached a different conclusion if the estate instead had "an obligation with respect to some of the victims to provide them with the securities they paid for" as is the case here. *See id*., at pp. 1211-12. Of course, here, the Receivership Order specifically contemplates that securities, rather than cash, will be returned to investors. *See* ECF No. 142 at p. 10.

If no QSF has yet been created, or if a QSF has been created but it only includes Receivership Funds and not the securities still held at Clear Sailing or pursuant to forward purchase contracts, then there is no reason why the Investor Group's portion of the distribution plan, provisionally approved by the Court months ago, cannot now be implemented without being subject to the potential 43% tax rate that the Receiver urges the Court to adopt in her version of the distribution plan.[5] The only question remaining then is whether there is any basis to select one distribution plan over the other based on cost or time to implement.

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[5] The Receiver has plainly not considered the potentially significant tax implications to investors if her plan is adopted and the securities are deemed part of the QSF as of October 2016. By way of hypothetical example, only , if an investor purchased $100,000 of Company X stock at $3.00 per share in 2014 and that stock is then valued at $6.00 per share on October 11, 2016 when placed in the Receiver's QSF, the investor may recognize a gain and owe tax on that gain (unless the investor had a loss carryover to offset the gain), plus four years of interest and penalties, for the $100,000 gain in the value of the stock at the time the QSF is created. If Company X then goes public at $12.00 per share, the QSF would likely pay a 43% tax rate on the $200,000 gain (when the stock is either sold in the QSF or distributed out of the QSF, assuming the same $12 value at the time of either sale or distribution), the expense of which would be borne by the investor indirectly. In contrast, under the Investor Group's plan and current tax rules, the investor would have no tax liability at all until those shares were sold by the investor, and then the sale would be taxed at a (footnote continued)

The Receiver devotes part of the December 16 filing to her claim that if she is ordered to implement the Investor Group's version of the distribution plan, this will be more expensive, more complicated, and take more time than the plans she proposes. But this is all speculation, unsupported by any facts. The Receiver complains that if the Investor Group's plan is adopted, she will need to incur the expense to seek a private letter ruling from the IRS, but provides no estimate how much that will cost, or whether it is even material in light of the overall value of the receivership estate. The Receiver admits that her distribution plans would result in a 43% tax rate, but has no idea what that might actually mean to investors since she has not obtained a baseline valuation for the securities as of October 11, 2016. And that baseline valuation the Receiver seeks will, of course, be an additional expense borne solely by investors and creditors for which no estimate has been provided. The Receiver has no basis to claim, as she does, that either of her proposed plans will be cheaper to implement than the Investor Group's plan.

As to the time needed to implement the different plans, all of the plans are dependent on the same liquidity events, so no one plan will be able to be implemented more quickly than another. And as to complexity, while the Investor Group's proposed plan may be somewhat more involved than those proposed by the Receiver, this is something the Receiver must have been aware of when she sought to be appointed, and hardly provides a basis for picking one plan over the other. Moreover, investors have sought to reduce the burden and cost of the Receiver by offering to assist in the implementation of the distribution plan through the investor advisory group. It is notable that the Receiver has not only not sought the assistance of any investors to date, but now seeks to get rid of the group entirely in her latest proposed distribution plan.

Any QSF created by the Receiver should include only Receivership Funds as that term is defined in the Receivership Order. To the extent some securities will be needed by the Receiver to pay administrative, tax and creditor claims, only those securities should be transferred into the QSF

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lower, long-term capital gains rate.

after there has been a liquidity event.[6] Securities that are to be distributed to investors should remain outside of the QSF since they do not constitute Receivership Funds. The Court should reject the Receiver's plan, which would place all securities into a QSF as of October 11, 2016 and reject the Receiver's alternative streamlined liquidation plan that contemplates not distributing any securities to any investors.

Finally, the Receiver should not be allowed to speculate in the securities market with respect to the timing of sales of securities as part of any tax mitigation strategy, as she proposes in the December 16 filing. The Receiver is not a competent securities market professional and has no expertise in investing or the market. She should not be allowed to gamble with the investors' and creditors' money as she proposes she be allowed to do.

RESPONSE RE PROPOSED CHANGES TO DISTRIBUTION PLAN

The Court should reject many of the Receiver's proposed changes to the version of the distribution plan attached to the December 16 filing. Mr. Cilano is not an insider, has never been considered an insider, and his claim has never been disallowed by the Court (p. 3). There is no basis for the Receiver's decision to remove the Investor Advisory Committee from the distribution plan, and no explanation has been provided (pp. 13-14). Section C – Tax Treatment and Apportionment of Tax Liability is inconsistent with the record, and must be revised to reflect when a QSF was actually created and that only Receivership Funds, not the Receivership Estate, are part of any QSF (pp. 18-19). Moreover, if the Investor Group's plan is adopted, no valuation of assets will be needed (p. 18). Finally, the Receiver should be required to consult with the Investor Advisory Group, not counsel for the Investor Group, with respect to any adjustments or amendments to any approved distribution plan (p. 19).

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[6] Because securities will only be transferred into the QSF after there has been a liquidity event and the securities are being publicly-traded, there is no need to incur the cost of hiring a valuation expert.

CONCLUSION

For all of the foregoing reasons, the Investor Group respectfully requests that the Court (i) order the Receiver to implement a distribution plan that incorporates the elements of the Investor Group's plan that the Court previously indicated it would adopt, (ii) reject most of the Receiver's latest round of changes to her distribution plan, (iii) instruct the Receiver not to file QSF tax returns at this time, and (iv) deny the Receiver's request to retain a valuation firm.

Respectfully submitted,

DATED: January 13, 2020

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