No. 16-56362

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,

JOSEPH M. ARDIZZONE, DAVID R. SCHWARZ, LOIS SCHWARZ,
DENNIS FRISMAN, ERIC GILBERT, AND RICK MOORE,
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
U.S. SECURITIES & EXCHANGE COMMISSION'S OPPOSITION
TO URGENT MOTION FOR STAY PENDING APPEAL

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I. Introduction

The Securities and Exchange Commission ("SEC") and Thomas C. Hebrank ("Hebrank") make the same points in their oppositions, with two exceptions. First, the SEC argues the groundless argument this motion should not be treated as urgent. Second, both oppositions silently concede the District Court erred by applying due process standards in deciding it has subject matter jurisdiction over the general partnerships ("GPs"), but the SEC labors to salvage the issue with other flawed theories. This reply addresses these issues, while the reply to Hebrank's opposition addresses his and the SEC's remaining overlapping contentions.

II. ARGUMENT

A. The SEC Fails To Grasp the Urgency of This Motion and the Appeal

The SEC makes three groundless objections to this Motion. First, the three-week "delay" between the District Court's Order denying a stay (D.[1] 1409) and the filing of this Motion related to a death in Appellants' counsel's immediate family. D.E. 11, ¶ 3. The SEC agreed not to oppose Appellants' motion for an extension to file briefs. Appeal No. 16-55850, D.E. 22 at 3. Appellants filed this motion nine days after their counsel returned from emergency leave, shortly after filing other briefs due under this Court's November 1, 2016, Order. *Id.* 16-55850, D.Es. 23-25.

[1] "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 in this Appeal. The pagination follows the page numbers as designated by CM/ECF.

Second, despite the SEC's claim, Appellants' counsel informed all parties in a brief filed in Appeal No. 16-55850 on December 19, 2016, that Appellants would be filing this motion for a stay. Appeal No. 16-55850, D.E. 28 at 6.

Third, the SEC's argument that Appellants failed to identify any pending sales of realty is contradicted by Appellants' assertion in their Motion that Hebrank had "obtained orders confirming the first two sales of GP properties." D.E. 11 at 2. Appellants will provide the Court an update on the pending sales of GP properties in its reply to Hebrank's opposition. Because the District Court has effectively barred Appellants from opposing any future sales on due process, jurisdictional, or other grounds previously raised (D. 1409 at 14), sales may be confirmed on 28-day notice without investor opposition, giving urgency to this Motion for a Stay.

B. Appellants Have Established They Will Likely Prevail on Appeal, Warranting a Stay

1. The SEC and Hebrank Concede the District Court Erred in Deciding It Has Subject Matter Jurisdiction over the GPs

On November 29, the District Court denied Appellants' motion for a stay and decided all issues in favor of the SEC and Hebrank. D. 1409. Among other things, the District Court stated it had "evaluated, and rejected" Appellants' contention that it lacked subject matter jurisdiction over the GPs at pages 13 through 16 of its May 25, 2016, order. D. 1409 at 9, ll. 9-16.

The District Court is mistaken. Its May 25 order does not address its subject

matter jurisdiction over the GPs. As demonstrated in the Graham Investors' supplemental brief, the District Court applied an erroneous legal standard—due process instead of jurisdiction—in its May 25 order in deciding it had jurisdiction over the GPs. Appeal No. 16-55850, D.E. 25-1 at 2-13.

The SEC's and Hebrank's continued silence on the District Court's stated grounds for its subject matter jurisdiction concedes it erred on this issue. Neither the SEC nor Hebrank even mentions the November 29 order in their respective oppositions. Likewise, neither contends the May 25 order addresses, much less decides, that the District Court has jurisdiction over the GPs. Both the SEC and Hebrank opposed the *filing* of the supplemental brief, but neither countered its core contention the District Court mistakenly applied due process principles in deciding it had subject matter jurisdiction over the GPs. And neither opposition addresses the condensed version of the same argument in Appellants' Motion. D.E. 11 at 10.

The SEC's and Hebrank's continued silence confirms the District Court applied the wrong standard in deciding it had subject matter jurisdiction over the GPs. Equally important, it establishes that Appellants' contentions on appeal—including that the District Court lacks jurisdiction over the GPs—are meritorious and likely to result in a reversal on appeal.

2. <u>The SEC Asserts Three Flawed Theories of Subject Matter Jurisdiction</u>

The SEC used a flawed legal theory to lead the District Court down a path

that has proved to be a disaster for 3,300 investors. It now tries to salvage this appeal with three flawed legal theories at odds with more than a century of precedent that would wreak havoc on the securities industry and its investors.

a. Contrary to The SEC's Argument, Inherent Power to Fashion Relief Does Not Supplant *in Rem* or *Quasi in Rem* Jurisdiction

First, citing *SEC v. Wencke*, 622 F.2d 1363, 1369 (9th Cir. 1980), the SEC argues a District Court has "inherent power of a court of equity to fashion effective relief." D.E. 13 at 6. But this misses the point. An equity court's power to fashion relief is separate from, and predicated on, the court having jurisdiction. Here, the District Court's inherent power to order the sale of nonparty's property cannot exist unless it first had *in rem* jurisdiction over the property. *See Republic Nat'l Bank of Miami v. United States*, 506 U.S. 80, 84 (1992) ("[T]he court must have actual or constructive control over the *res* when an *in rem* forfeiture suit is initiated."); *O'Neil v. Welch*, 245 F. 261, 266 (3d Cir. 1917) ("[T]he court which first obtained control of the property . . . first acquires jurisdiction."). The very case the SEC cites recognizes this point. *See Wencke*, 622 F.2d at 1371-1372) (date of actual possession by the receiver determines *in rem* jurisdiction); *SEC v. Hickey*, 322 F.3d 1123, 1125 (9th Cir. 2003) (A district court may freeze the assets of a nonparty *when* it is dominated and controlled by defendant)

In *SEC v. Am. Capital Invs.*, 98 F.3d 1133, 1144 (9th Cir. 1996), this Court reiterated that a court of equity "having custody and control of property" has the

power to order a sale of the same, which "necessarily *follows* the power to take possession and control of and to preserve property (emphasis added; internal quotation marks and citations omitted.)." The principle that a district court's jurisdiction over a nonparty's assets only exists if the court has possession and control over those assets extends far beyond receivership cases to a long list of *in rem* and *quasi in rem* proceedings. *See Princess Lida of Thurn & Taxis v. Thompson*, 305 U.S. 456, 466-467 (1939); *U.S. v. Bank of New York & Trust Co*., 296 U.S. 463, 477 (1936) ("[T]he court must have possession or control of the *res* in order to proceed with the cause and to grant the relief sought.") In short, a District Court cannot obtain possession and control from a defendant who does not have it to yield, as here. It therefore lacks jurisdiction over nonparty property.

b. Notice and Hearing Are the Protections of Due Process, Not the Elements of *in Rem* Or *Quasi in Rem* Jurisdiction

Second, citing *In re San Vicente Med. Partners Ltd.*, 962 F.2d 1402, 1406-08 (9th Cir. 1992), the SEC argues that "a district court has the power to include the property of a non-party limited partnership in an SEC receivership order as long as the non-party. . . receives actual notice and an opportunity for a hearing." D.E. 13 at 7. But this proposition from *San Vicente* recites due process principles for including the property of nonparties in a receivership, which again, applies only if the District Court has jurisdiction over nonparty's property. This, in turn, depends on whether the defendant had control over the property when the case was filed.

In *San Vicente*, defendants indisputably "controlled San Vicente and all of its property" when the SEC filed its case. 962 F.2d at 1407. Here, by contrast, the opposite is true—defendants indisputably did *not* control the GPs when the SEC filed its case, as discussed below.

The SEC mistakenly argued to the District Court in its 2012 *ex parte* motion that it could include the GPs in the receivership by following the *San Vicente* due process guidelines without independently ascertaining its jurisdiction over the GPs. D. 3 at 31, ll. 12-20. The District Court mistakenly embraced and applied *San Vicente*'s due process principle throughout the case *without analyzing whether it had quasi in rem jurisdiction over the GPs*. In their supplemental brief, the Graham Investors track how this error has been welded into the structure of the underlying case, and, ironically, explain how *San Vicente* offers the remedy to fix it.

c. The Indisputable Fact That Defendants Did Not Control the GPs at the Time the SEC Filed Its Case Establishes the Lack of Jurisdiction

Finally, the SEC sets up and knocks down a straw man. It argues: "The Ardizzone Investors argue that *San Vicente* is not dispositive here because defendants Schooler and Western ***never*** controlled the GPs (emphasis added)." D.E. 13 at 7. But that is not Appellants' actual contention. Rather, Appellants argue: "The court must obtain control of those assets from the defendants *when the case is filed*.…" D.E. 11 at 11.

The SEC retains the burden to establish the District Court's jurisdiction over

the GPs. *Kelly v. Wengler*, 822 F.3d 1085 (9th Cir. 2016). This Court reviews *de novo* the issue of law inherent in ascertaining the jurisdictional limits to the District Court's power in equity receivership proceedings. *Am. Capital Inv.*, 98 F.3d at 1142. The SEC must overcome two undisputed facts to prove that defendants controlled the GPs: that investors (1) collectively own 94% of the GPs[2] and (2) hold 100% of the voting power. D. 1293-3 ¶ 15 and Ex. 10. Here, the SEC cannot, and does not, overcome either fact, and, therefore, fails to meet its burden.

The District Court never addressed whether defendants controlled the GPs in the context of its jurisdiction over them. Instead, the SEC got the parties to stipulate to subject matter jurisdiction (D. 174), a stipulation which itself was unlawful and void. *Singer v. State Farm Mut. Auto. Ins. Co.*, 116 F.3d 373, 376 (9th Cir. 1997). The control issue arose three times in the context of whether the GPs were securities under the *first* factor of *Williamson v. Tucker*, 645 F.2d 404 (5th Cir. 1981). The factor is satisfied if an agreement "leaves so little power in the hands of the partner … that [it] in fact distributes power as would a limited partnership." *Id.* at 424. In short, is the entity a *de facto* limited partnership?

The SEC first asserted that the GPs were *de facto* limited partnerships in its motion for a preliminary injunction, arguing that "Defendants control [the GPs] and their assets." D. 3 at 31, l. 1. This contention, if true, would bring this case

[2] According to Mr. Hebrank, Defendant Western holds a 6% interest in the GPs. D. 852-1 at 4, Ex. A. The remaining 94% interest is held by the investors as partners.

within the scope of *San Vicente*, where the defendant controlled San Vicente, the limited partnership, and its assets. *Id.* at 31, l.15. But the District Court held the SEC's claim that defendants controlled the GPs as *de facto* limited partnerships "missed the mark" and gave multiple reasons why they lacked it. D. 44 at 7-8.

The District Court addressed the same issue a second time when defendants moved to dismiss the SEC's complaint. The District Court assumed that the SEC's allegations were true, but still held that the SEC failed to allege that defendants controlled the GPs. D. 212 at 6, l. 24.

The issue arose a third time when the SEC and Defendants sought summary judgment on whether the GPs were securities. Ds. 542 and 563. This time, the SEC abandoned its rejected theory that the GPs were *de facto* limited partnerships. Instead it argued a variant of the same theory—that defendants controlled the GPs *during the offering period;* the GP Agreements were not effective until after the close of the GP offering; and control *during the offering* was the test for deciding whether the GPs were securities. D. 552 at 18-22, D. 563-1 at 17-20.

The District Court agreed that the GP agreements were securities because defendants had control during the offering period—at the time of the original investment—but found that the control passed to investors when the GP agreements became operative. D. 583 at 15. Thus, the investors had control of the GPs when the SEC filed its case, the relevant time for the jurisdictional analysis.

Based on this record, two conclusions are self-evident: (1) the GP agreements were securities because defendants controlled the GPs *during the offering*; and (2) the District Court lacks jurisdiction over the GPs because the defendants did not control them *when* the case was filed. Because this appeal challenges the District Court's placement of the GPs in the receivership based on lack of jurisdiction when the case was filed, Appellants have established a likelihood of prevailing on appeal.

3. The SEC's Attempt to Establish that the GP Agreements Were Securities under Other Theories Fails

As a last gasp, seizing two scraps of texts from 1,400 filings, the SEC argues the GP agreements are securities under other theories and, as such, the GPs were properly included in the receivership. But this ignores the District Court's findings on three separate occasions that the GPs were not limited partnerships when the case was filed, and its final holding that the GP agreements were securities on only one theory—control during the offering—and not control when the case was filed.

In essence, the SEC contends that a receiver may be appointed to seize any security that changed hands during an alleged violation of the securities acts. This unprecedented extension of the District Court's *quasi in rem* jurisdiction would mean that a receiver could be appointed in every SEC case, since every SEC case involves a security changing hands. A security that had come to rest in investors'

possession decades earlier, such as the GP agreements here, would be subject to seizure and divestment. All securities would forever be at risk of a receivership. No case even hints at supporting such a theory.

Moreover, the SEC's newly minted theory would upend the principles of comity that state and federal courts yield *in rem* or *quasi in rem* jurisdiction to the court which first has control over the property. The SEC's theory that a court has jurisdiction over any security that changed hands during an alleged violation would create a unique caveat to this venerable principle. It would no doubt compromise judicial harmony through "state and federal judicial systems attempting to assert concurrent control over the *res*." *Sexton v. NDEX West*, 713 F.3d 533, 536 (9th Cir. 2013).

III. CONCLUSION

For the reasons set forth above, and in Appellants' moving papers, as well as the Graham Investors' filings in Appeal No. 16-55850, Appellants respectfully request that this Court grant their urgent Motion for a Stay.

DATED: January 12, 2017

Aguirre Law, APC

By: /s/ Gary J. Aguirre
GARY J. AGUIRRE
Attorney for Appellants

CERTIFICATE OF COMPLIANCE

The foregoing Reply to U.S. Securities & Exchange Commission's Opposition to Urgent Motion for Stay Pending Appeal complies with the type-volume limitations of Fed. R. App. P. 32(a)(7)(B) because: This brief contains 2,520 words, excluding the parts of the brief exempted by Fed. R. App. P. 32(a)(7)(B)(iii). This brief complies with the typeface requirements of Fed. R. App. P. 32(a)(6) because it was prepared in a proportionally spaced typeface using Microsoft Word 2007, in font size 14, Times New Roman.

DATED: January 12, 2017

Aguirre Law, APC

By: /s/ Gary J. Aguirre
GARY J. AGUIRRE
Attorney for Appellants

CERTIFICATE OF SERVICE

I hereby certify that I electronically filed the foregoing reply, declaration and exhibits with the Clerk of the Court for the United States Court of Appeals for the Ninth Circuit by using the CM/ECF system on January 12, 2017. I certify that all participants in the case are registered CM/ECF users and that service will be accomplished by the appellate CM/ECF system.

DATED: January 12, 2017 Aguirre Law, APC

By: /s/ Gary J. Aguirre
GARY J. AGUIRRE
Attorney for Appellants

ATTACHMENT 1,
INTERVENORS-APPELLANTS

Susan Graham, Alfred L. Pipkin, Alfred L. Pipkin, IRA, Allert Boersma, Arthur V. and Kristie L. Rocco Living Trust, Arthur V. Rocco, Baldwin Family Survivors' Trust, Barbara Humphreys, IRA, Beverly & Mark Bancroft, Beverly A. Bancroft, IRA, Bruce A. Morey IRA, Bruce A. Morey, Bruce R. Hart IRA for Bruce R. Hart and Dixie L. Hart, Carol D. Summers, Carol Jonson, Catherine E. Wertz IRA, Catherine E. Wertz, Cathy Totman, IRA, Charles Bojarski, Chris Nowacki, IRA, Cindy Dufresne, Craig Lamb, Curt & Janean Johnson Family Trust, Curt & Janean Johnson, jointly, Curt Johnson, Curt Johnson, Roth IRA, Cynthia J. Clarke, D & E Macy Family Revocable Living Trust, D.F. Macy IRA, Daniel Burns, Daniel Knapp, Darla Berkel IRA, Darla Berkel, Daryl Dick, David and Sandra Jones Trust, David Fife IRA, David Haack IRA, David Haack, David Karp IRA, David Kirsh, David Kirsh, Roth IRA, David Kirsh, Traditional IRA, Debra Askeland, Deidre Parkinen, Dennis Gilman, Dennis Gilman IRA, Diane Bojarski, Diane Gilman, Donna M. and Richard A. Kopenski Family Trust, Donna M. Kopenski, IRA Roth, Douglas G. Clarke, Douglas Sahlin IRA, Eben B. Rosenberger, Edith Sahlin IRA, Edward Takacs, Ellen O'Brien, Elizabeth Lamb, Norling, Eric W. Norling, IRA, Gary Hardenburg, Gary Hardenburg, Roth IRA, Gene Fantano, George Klinke, IRA, George Trezek, Gerald Zevin, Gerald Zevin, IRA, Gwen Tuohy, Gwenmarie Hilleary, Henrik Jonson, Henrik Jonson, IRA, IDAC Family Group LLC, Iris Bernstein IRA, James J. Coyne Jr. Trust, Janice Marshall, Janice Marshall, IRA, Jason Bruce, Jeffrey Merder, IRA, Jeffrey J. Walz, Jeffrey Larsen, Jeffrey Merder, Jennifer Berta, Jim Minner, Joan Trezek, John Jenkins, John and Mary Jenkins Trust, John and Mary Jenkins Trustees, John Lukens, John Lukens, IRA, John R. Oberman, Joy A. de Beyer, Roth IRA, Joy A. de Beyer, Traditional IRA, Joy de Beyer, Juanita Bass IRA, Juanita Bass, Judith Glickman Zevin, IRA, Judith Glickman Zevin, Judy Knapp, Karen Coyne, Karen J. Coyne IRA, Karen Wilhoite, Karie J. Wright, Kimberly Dankworth, Kirsh Family Trust UTD, Kristie

ATTACHMENT 1,
INTERVENORS-APPELLANTS

L. Rocco, Lawrence Berkel, Lawrence Berkel, IRA, Lea Leccese, Leo Dufresne, Leo T. Dufresne Jr. IRA, Linda Baldwin IRA, Linda Clifton, Lisa A. Walz, Lloyd Logan and Ida Logan, jointly, Lloyd Logan, IRA, Lynda Igawa, Marc McBride, Marcia McRae, Marilyn L. Duncan, Mark Clifton, Mary Grant, Mary J. Jenkins, IRA, Mathew Berta, Mealey Family Trust, Michael R. Wertz, Michael R. Wertz, IRA, Mildred Mealey, beneficiary of Duane Mealey IRA, Minner Trust, Monica Takacs, Monique Minner, Neil Ormonde, IRA, Nevada Ormonde, IRA, Paul Leccese, Paul R. Sarraffe, IRA, Perryman Family Trust, Polly Yue, Prentiss Family Trust, Kenneth and Gail Prentiss Trustees, Ralph Brenner, Randall S. Ingermanson IRA, Rebecca Merder, Reeta Mohleji, Regis T. Duncan, IRA, Regis T. Duncan, Renee Norling, Richard A. Kopenski, IRA Roth, Robert Indihar, Robert Churchill Family Trust, Robert Churchill IRA, Robert H. Humphreys, Robert Indihar IRA, Robert S. Weschler, Robert Tuohy, Roderick C. Grant, Roger Hort, Roger Moucheron, Ronald Askeland, Ronald Parkinen, Ronald Scott, Ronald Scott, IRA, Salli Sammut Trust, Salli Sue Sammut Trustee, Salli Sue Sammut, IRA, Shirley Moucheron, Stephen Dankworth, Stephen Hogan, Stephen Yue, Steve P. White, IRA, Steve P. White, SEP IRA, Susan Burns, Tamara and Chris Nowacki, jointly, Tamara Nowacki, IRA, The Knowledge Team Profit Sharing Plan, The Ormonde Family Trust, Thomas H. Panzer, Roth IRA, Thomas Herman Panzer Trust, Thomas H Panzer, Trustee, Trisha Bruce, Val Indihar, W.C. Wilhoite, W.C. Wilhoite, Roth IRA, William C. Phillips, William L. Summers, IRA, William L. Summers, William Loeber, William Nighswonger IRA, William R. Nighswonger, William R. Rattan Rev. Trust, William V. and Carol J. Dascomb Trust, Carmen Slabby, Lawrance Slabby, Virginia Kelly, James S. Dolgas, Penco Engineering, Inc. Profit Sharing Pension Fund, George Jurica, and George Jurica IRA.