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3:04-CV-02295 SEC V. EMVEST MORTGAGE FUND
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RPLY.

1 ROBERT S. BREWER, JR., ESQ. (SBN 65294)
ROBERT A. COCCHIA, ESQ. (SBN 172315)
2 JOSEPH N. CASAS, ESQ. (SBN 225800)
McKENNA LONG & ALDRIDGE LLP
3 750 B Street, Suite 3300
San Diego, CA 92101
4 Telephone: (619) 595-5400
Facsimile: (619) 595-5450
5

6 Attorneys for Defendants EMVEST MORTGAGE FUND,
LLC; EMVEST, INC.; and MILON LYLE BROCK
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CLERK, U.S. DISTRICT COURT
SOUTHERN DISTRICT OF CALIFORNIA
BY: *Esquivel* DEPUTY

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9 UNITED STATES DISTRICT COURT
10 SOUTHERN DISTRICT OF CALIFORNIA

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12 SECURITIES AND EXCHANGE
COMMISSION,

13 Plaintiff,

14 v.

15 EMVEST MORTGAGE FUND, LLC;
16 EMVEST, INC.; and MILON LYLE BROCK,

17 Defendants.
18

CASE NO. 04 CV 2295 DMS (POR)

DEFENDANTS' REPLY TO
SECURITIES AND EXCHANGE
COMMISSION'S RESPONSE TO
THIRD VERIFIED REPORT OF
RECEIVER

[SPECIAL BRIEFING SCHEDULE
ORDERED]

Date: September 30, 2005
Time: 10:30 a.m.
Judge: Hon. Dana M. Sabraw
Courtroom: 10

19
20 I.

21 INTRODUCTION

22 In November 2004, before discovery commenced, the SEC obtained the appointment of a
23 receiver based on the declaration of Kelly Bowers and the SEC's groundless allegations of a
24 "Ponzi" scheme. Now, nine months later, the Court must consider Mr. Murphy's Third Report to
25 determine whether the justification for the receivership still remains. It does not. As facts slowly
26 take the place of allegations, any basis to continue the receivership has evaporated. The Fund's
27 investors should be freed of the financial burden the receivership has imposed on the Fund.
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ORIGINAL

1 In its Response, the SEC does not argue that the Third Report justifies the continuation of
2 the receivership. Rather, the SEC repeats its mantra, first made in November, that the
3 receivership should continue simply because the Court found a *prima facie* case of securities
4 fraud.

5 However, the focus of the hearing on the Third Report is not to revisit the original
6 justifications for the receivership (*i.e.*, the state of the evidence in November 2004), but rather to
7 reexamine the propriety of the receivership based on the facts as they are known today and as
8 presented in the Third Report. When considered in light of these facts, the continuation of the
9 receivership is no longer justified.

10 II.

11 THE EVIDENCE FAILS TO ESTABLISH THAT DEFENDANTS 12 VIOLATED FEDERAL SECURITIES LAWS

13 The SEC argues that four purported “facts” either elicited through discovery or referenced
14 in the Third Report support the continuation of the receivership. In doing so, the SEC
15 misrepresents the record. However, even taking the SEC’s arguments at face value, it fails to
16 present sufficient justification for the continuation of the receivership.

17 A. The Decker Testimony Does Not Establish Securities Law Violations.

18 The SEC refers to the deposition of Bruce Decker, a former Fund sales person, to suggest
19 that Defendants have violated securities laws. The SEC claims that Mr. Decker testified that he
20 told investors that they would receive back all of their original capital investment at the end of
21 Fund’s life (December 2008), and that Mr. Decker thought that the Fund was making 12%
22 returns.

23 First, even if true, the fact that Mr. Decker may have told investors that they would
24 receive 12% distributions (which they undisputedly did) and then receive back all of their capital
25 does not justify the continuation of the receivership. Noticeably absent from the SEC’s Response
26 is any citation to testimony that Defendants instructed Mr. Decker (or any other salesperson) to
27 make such representations or that Defendants authorizes such statements. That is because there is
28 no such evidence.

1 Second, the SEC mischaracterizes Mr. Decker's testimony by omitting relevant
2 qualifications to his answers. It is true that Mr. Decker testified that investors would receive their
3 capital contribution in 2008. However, it is also true, although not cited by the SEC, that Mr.
4 Decker testified that he went over—indeed, highlighted and circled—with each of his investors
5 key disclosures about the Fund, including the sections that undisputedly disclose that the 12% is
6 not a yield, but, rather, a priority distribution and that the investors' capital balance may decrease.
7 *See*, Casas Decl., Ex. 1. (Decker Depo, pp. 151:10 – 155:20). The substance of Mr. Decker's
8 testimony, when taken in full context, is as follows: (1) Defendants never instructed or authorized
9 Mr. Decker to represent that the Fund paid a 12% yield and that investors would receive 100% of
10 their original invested capital upon dissolution; and, (2) Mr. Decker reviewed in depth with his
11 clients the risk, distribution, and capital account information contained in the Fund's prospectus.

12 As set forth clearly in the prospectus, potential investors were advised that the investment
13 involved "a high degree of risk" and "[t]here can be no assurance of return of investor capital."
14 Contrary to the unsupported allegations of the SEC, the investors were advised that they may or
15 may not receive their original capital investment back at the termination of the fund. What they
16 were told, and advised in writing, was that "Shareholders are entitled on a cumulative but non-
17 compounding basis, payable monthly in arrears, to a 12% per annum priority return on their
18 original invested capital, as reduced by cumulative Priority Operating Return Distributions to the
19 Shareholders." Thus, Shareholders were entitled to 1% of their capital account every month,
20 whether that capital account was made up of original capital only, the Shareholders' share of
21 profits obtained by the Fund, or some combination of both. The SEC ignores this undisputed
22 evidence. The prospectus also advises the Shareholders that their capital accounts would be
23 "decreased by their distributive share of net losses of the Company and also the amount of cash
24 distributions made to such Shareholder."

25 Very simply, the SEC's argument that the Fund or its sales persons guaranteed a 12%
26 profit dividend, and no reduction of capital, flies in the face of the facts. The limited portions of
27 Mr. Decker's testimony extracted by the SEC does not support the continuation of the
28 receivership.

1 **B. The Third Report Does Not Establish That The Defendants Violated Securities**
2 **Laws.**

3 The SEC argues that the Third Report reveals capital “erosion” of more than \$2.3 million.
4 Defendants addressed this argument in detail in their Response to the Third Report, and will not
5 repeat that argument here. However, some additional points are noteworthy. First, the “eroded”
6 capital (as the SEC characterizes the reduction of investors capital accounts), to the extent any
7 capital was actually reduced, was by virtue of the funds being returned to the investors
8 themselves! There is no nefarious misdirection of monies or other diversion. Rather, any
9 reduction in an investor’s capital account was the result of that investor receiving a distribution
10 that, in addition to being comprised of the Fund’s profits, might include a portion of the investor’s
11 capital. As set forth above, this possibility was disclosed in the Fund’s prospectus. Second, as
12 detailed in Defendants’ response, Mr. Murphy—who, unlike Defendants, has been ordered by this
13 Court to limit distributions to the lesser of net income or 6%—has actually distributed more than
14 his net income. That is, Mr. Murphy has committed the very same “erosion” that the SEC (and
15 the receiver) cites in opposition to Defendants.

16 Most relevant to the present hearing is the fact that, even if investors’ capital was
17 “eroded,” this fact would not support the continuation of the receivership. The Court has already
18 fashioned an Order limiting Mr. Murphy’s ability to make distributions. *See*, March 2, 2005
19 Order, pg. 19. As discussed in Defendants’ Response to the Third Report, there is no evidence
20 whatsoever that Defendants would not abide by such an order. Allegations of capital “erosion”
21 do not support the continuation of the receivership.

22 **C. The Kornfeld & Levy Memo Was Not a “Warning,” and Does Not Evidence**
23 **Violations of Securities Laws.**

24 Since the beginning of this case, the SEC has repeatedly mischaracterized an August 16,
25 2003 memo sent from the Fund’s accountants, Kornfeld & Levy. The SEC portrays this memo as
26 a “warning” to the Fund’s management that investor distributions were exceeding income and
27 that the Fund should stop this practice. The SEC then goes on to claim that Defendants “ignored”
28 this warning in an attempt to establish *scienter*. However, the depositions of both Messrs.

1 Kornfeld and Levy have revealed that the memo does not stand for the proposition repeatedly
2 espoused by the SEC.

3 The author of the memo, Gary Kornfeld, testified in his deposition that the memo simply
4 addressed the fact that when a few investors withdrew from the Fund, they received a payout
5 based on their original or most recently reported, rather than current, capital balances. Kornfeld
6 & Levy's concern was limited to an accounting one—they had to rebalance the remaining
7 investors' capital accounts in connection with the preparation of the Fund's tax returns. The
8 memo did not address the *propriety* of making distributions in excess of income, or otherwise
9 serve as a "warning" about anything. Indeed, the memo demonstrates that Mr. Kornfeld knew
10 and understood that the investors capital accounts could be reduced in the operation of the Fund.
11 Moreover, Mr. Kornfeld testified that the next time he reviewed the Fund's financials, that
12 management had made significant improvements to address the issues raised in his memo. That
13 is, management heeded and responded to his memo. If anything, the August 16, 2003 Kornfeld &
14 Levy memo and Mr. Kornfeld's testimony serve as additional factors negating *scienter*.

15 As with virtually every issue presented in this case (*e.g.*, the allegations of a "Ponzi"
16 scheme, the claim that the Fund was not a sustainable business model, and the claim that funds
17 were "diverted" by Defendants), the SEC's position is flatly contradicted by the facts.

18 **D. Allegations Concerning Loan-To-Value Ratios Do Not Justify the Continuation of**
19 **the Receivership.**

20 In his Third Report, Mr. Murphy contends that certain loans made by Defendants on
21 property in Florida exceeded the maximum loan-to-value ("LTV") ratios provided in the
22 prospectus. The SEC cites Mr. Murphy's contention as further support for the continuation of the
23 receivership.

24 Once again, the SEC's argument demonstrates a critical lack of understanding of the facts.
25 The purchase price that Defendants actually paid for these loans is well within the Fund's LTV
26 guidelines. The Fund did not make these loans, but rather purchased them as a portfolio, at a
27 substantial discount. Mr. Murphy alleges that many of the loans were made at 100% LTV, but he
28 ignores the fact that the properties securing these loans had appreciated from the time they were

1 originated. He also discloses that the portfolio was purchased at only 52.5% of the face value of
2 the loans. While we have previously disputed the manner in which he accounts for the
3 acquisition of this portfolio, we assert that this discount and the appreciated value of the securing
4 property resulted in a portfolio acquisition that was compliant with the prospectus.

5 As discussed more fully in Defendants' Response to the Third Report, several of these
6 loans, which Mr. Murphy deems to be "bad," are paying off. In fact, one has paid off in full.¹
7 Given this fact, of which the receiver is undoubtedly aware, Defendants are concerned that the
8 receiver is not providing full and unbiased information to the Court for its consideration. The
9 existence of these Florida loans does not evidence violations of securities laws and does not
10 justify a receivership. Moreover, the receivership does nothing to protect against whatever
11 damage the SEC wants to allege resulted from the purchase of this loan portfolio six months prior
12 to the filing of this action. This argument is simply another unwarranted attempt to disparage and
13 discredit Defendants. They do not advance any of the issues in this case.

14 III.

15 THE COSTS OF THE RECEIVERSHIP ARE NOT WARRANTED

16 The SEC argues that the cost of the receivership is warranted because the Fund's profits
17 cover Mr. Murphy's costs. But no matter the level of profits earned by the Fund under Mr.
18 Murphy's stewardship, every dollar of his fees is money that otherwise would have gone to, or
19 been invested on behalf of, the Fund's investors. The pivotal question is: What are the Fund's
20 investors receiving in exchange for this expense?

21 Unfortunately, the answer is: very little. As detailed in Defendants' Response to the Third
22 Report, Mr. Murphy is failing to provide the Court with the one thing that is, arguably, paramount
23 of his duties—neutrality. Time and time again, Mr. Murphy has shown that his interests lie in
24 advocating for the SEC and justifying his receivership, rather than in providing a fair and
25

26 ¹ The receiver's contention, in his reply, that the write-offs followed GAAP procedures misses the
27 point entirely. The point is that Mr. Murphy's characterization of the loans as "bad" is proven to
28 be false.

1 unbiased assessment to the Court. Moreover, as discussed below, it appears from the documents
2 provided by the receiver to Defendants that Mr. Murphy's receivership may actually be putting
3 the Fund at great risk as a result of improper and non-compliant loans.

4 IV.

5 **MR. MURPHY'S RECEIVERSHIP UNNECESSARILY PLACES THE**
6 **FUND'S ASSETS AT RISK**

7 Over the past few months, Mr. Murphy has reinitiated the Fund's business of funding
8 loans. Since May of this year, Mr. Murphy has funded twelve loans. Defendants recently
9 reviewed loan documents provided by Mr. Murphy's office. The review of the loan documents
10 indicates that 2/3 of the loans funded by Mr. Murphy violate several lending laws. One loan in
11 particular unnecessarily exposed the Fund by extending credit on an unsecured loan. This is
12 something that Defendants have never done, and is contrary to Mr. Murphy's claims of operating
13 the Fund in a more conservative manner. By violating these laws, Mr. Murphy has also violated
14 the Fund's prospectus by placing the Fund at grave risk of not being able to collect on the loans.
15 Mr. Murphy's actions and/or omissions in failing to adhere to the laws that regulate the mortgage
16 industry, and the risk he has created for the Fund, is a manifest indication that Mr. Murphy is not
17 suited to manage the Fund.

18 A. **Mr. Murphy Has Violated Lending Laws.**

19 The practice of lending is primarily regulated by five statutes: the Real Estate Settlement
20 Procedures Act², the Truth In Lending Act - Regulation Z³, the Equal Credit Opportunity Act⁴
21 (collectively referred to as "Fair Lending Laws"), and federal⁵ and state⁶ laws which prescribe
22 limitations and requirements for high-cost loans (collectively referred to as "High-Cost Lending
23 Laws"). Whether a loan is "covered" by, or exempt from, either Fair Lending Laws or High-

24 _____
25 ² 12 U.S.C. §§2601-2617 (2005).

26 ³ 15 U.S.C. §1640 et. seq. (2005).

27 ⁴ 15 U.S.C. §1691 et. seq. (2005).

28 ⁵ 15 U.S.C. §1639 (2005).

⁶ Cal. Fin. Code §4970 et. seq. (2005).

1 Cost Lending Laws depends on several factors and variables. Lenders (such as Mr. Murphy)
2 have a duty to conduct due diligence on each loan to ensure compliance with these lending laws.
3 Moreover, lenders have an affirmative responsibility to correctly establish whether they are
4 making high-cost loans, and if so, to give appropriate disclosures, observe additional limitations,
5 and follow additional procedures.

6 Of the twelve loans made by Mr. Murphy eight loans endangered the Fund by non-
7 compliance with lending laws. *See*, Casas Decl., Ex. 2. Five loans are in violation of the basic
8 Fair Lending Laws. *Id.* at ¶ 2. Five loans violate federal High-Cost Lending Laws. *Id.* And
9 seven loans violate California High-Cost Lending Laws. *Id.* In total, Mr. Murphy has placed
10 \$1,436,250 of the Fund's portfolio at risk. *See*, Casas Decl., Ex. 3. Violations of Fair Lending
11 Laws and High-Cost Lending Laws carry varying degrees of penalties. For example, a violation
12 of California High-Cost Lending Laws carries potential penalties of license suspension by the
13 California Department of Real Estate and Department of Corporations, actual damages and
14 attorneys fees, a \$15,000 penalty if the violation was willful, punitive damages, and
15 disgorgement. *See*, Cal. Fin. Code §4974-4979.5 (2005). While some of these penalties could be
16 borne by Mr. Murphy, the Fund is ultimately at grave risk.

17 **B. Mr. Murphy Is Reckless and Negligent In Managing The Fund.**

18 Beyond compliance violations, some of Mr. Murphy's lending decisions present an
19 extraordinary hazard to the Fund. For example, in funding the "Poirier" loan, Mr. Murphy
20 caused a breach in security of the Fund's asset. *See*, Casas Decl., ¶ 9. It appears that Mr. Murphy
21 authorized a release of \$250,000 (50% of the note!) to the borrower *before* recordation of the trust
22 deed. *Id.* Although the loan was eventually paid off, the loan was an unsecured loan for five
23 days. *Id.* Any number of events could have occurred during those five days which would have
24 resulted in irreparable harm to the Fund (*e.g.*, death of the borrower, intentional fraud, etc.).

25 Although Mr. Murphy might be quick to respond with a "no harm, no foul" excuse for the
26 "Poirier" loan, other recent loans continue to jeopardize the Fund and highlight Mr. Murphy's
27 negligence and recklessness in managing the Fund. The recent "Sanchez" loan, in addition to
28 being devoid of required disclosures, lacks crucial clauses which protect the note, and contains

1 improper payments made directly to a sales licensee rather than to the employing broker. *Id.* at ¶
2 13. In the “Gonzalez” loan, Mr. Murphy took what was a perfectly compliant loan (it contained
3 all the appropriate documents) and caused it to be a “covered” loan under High-Cost Lending
4 Laws by shortening the term of the note from its original five year term to a 24-month term. *Id.*
5 at ¶ 11. To make matters worse, Mr. Murphy left the balloon payment on the note unchanged at
6 \$34,691.26; if this payment is enforced it will result in a \$4,999.89 loss of principal to the Fund.
7 *Id.*

8 Mr. Murphy’s negligence jeopardizes the Fund’s California Finance Lender’s License,
9 and thus its ability to continue lending in the future. Moreover, Mr. Murphy’s violations of both
10 Fair Lending Laws and High-Cost Lending Laws could cost the Fund a *minimum* loss of
11 \$147,302. *See, Casas Decl.*, ¶ 15. Contrary to Mr. Murphy’s representations made to the court,
12 it appears that there are no underwriting procedures indicating the process of approving loans,
13 such as compliance worksheets and/or checklists. There is no evidence of the procedures Mr.
14 Murphy claims to establish, and the fact that there are so many violations is not surprising. *See,*
15 *Casas Decl.*, ¶ 2. The recent dates of these violations not only indicate the absence of a learning
16 curve on Mr. Murphy’s behalf, but also evince a blatant and reckless disregard for the Fund’s
17 prospectus.

18 **C. Mr. Murphy Continues to Violate the Fund’s Prospectus.**

19 The Fund’s prospectus contains many disclosures and assurances to investors. As stated
20 above, Mr. Murphy’s manifold violations of Fair Lending Laws, High-Cost Lending Laws, and
21 reckless lending practices, indicate a complete lack of underwriting or compliance procedures in
22 his loan origination process. To be sure, the Prospectus assures investors that loans acquired by
23 the Fund will be “subject to an underwriting process intended to assess both the prospective
24 borrower’s credit history and ability to repay the Loan, and the value of the security for the Loan
25 requested.” Out of the twelve loans funded, it appears Mr. Murphy only verified income on one
26 loan. *See, Casas Decl.*, ¶6 . The remaining eleven indicate that Mr. Murphy failed to consider
27 whether the borrower’s income was sufficient for repayment. Mr. Murphy’s actions violate both
28 the spirit and the letter of the Fund’s prospectus.

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V.

CONCLUSION

The Fund's investors are not receiving any value in return for the significant expense they are asked to bear as a result of Mr. Murphy's services. His pattern of reckless lending practices is the most recent evidence of Mr. Murphy's ineffective management of the Fund. More importantly, Mr. Murphy cannot provide the Court with an unbiased picture of the Fund. Consequently, the receivership should be terminated and the Fund returned to its rightful management, with whatever restrictions the Court deems necessary.

Dated: September 14, 2005

McKENNA LONG & ALDRIDGE LLP

By: 

Robert S. Brewer, Jr.
Robert A. Cocchia
Joseph N. Casas
Attorneys for Defendants,
EMVEST MORTGAGE FUND, LLC;
EMVEST, INC.; and MILON LYLE BROCK

SD:22138912.1

3 **PROOF OF SERVICE**

4 I, Leslie D. Sharpe, declare:

5 I am a citizen of the United States and employed in San Diego County, California. I am
6 over the age of eighteen years and not a party to the within-entitled action. My business address
7 is Suite 3300, Symphony Towers, 750 B Street, San Diego, California 92101. On
8 **September 14, 2005**, I served a copy of the within document(s):

- 9
- 10 • ***DEFENDANTS' REPLY TO SECURITIES AND EXCHANGE***
11 ***COMMISSION'S RESPONSE TO THIRD VERIFIED REPORT OF***
12 ***RECEIVER***
 - 13 • ***DECLARATION OF JOSEPH N. CASAS IN SUPPORT OF DEFENDANTS'***
14 ***REPLY TO SECURITIES AND EXCHANGE COMMISSION'S RESPONSE***
15 ***TO THIRD VERIFIED REPORT OF RECEIVER***

16 by transmitting via facsimile the document(s) listed above to the fax number(s) set
17 forth below on this date before 5:00 p.m.

18 by placing the document(s) listed above in a sealed envelope with postage thereon
19 fully prepaid, in the United States mail at San Diego, California addressed as set
20 forth below.

21 by personally delivering the document(s) listed above to the person(s) at the
22 address(es) set forth below.

23 Susan F. Hannan, Esq.
24 Jose Sanchez, Esq.
25 Securities and Exchange Commission
26 5670 Wilshire Boulevard, 11th Floor
27 Los Angeles, CA 90036
28 Tel. (323) 965-3998 / Fax (323) 965-3908

***Attorneys for Plaintiff SECURITIES
AND EXCHANGE COMMISSION***

James R. Felton, Esq.
Greenberg & Bass
16000 Ventura Blvd., Suite 1000
Encino, CA 91436
Tel (818) 986-5687 / Fax (818) 986-6534

***Attorneys for Receiver DENNIS
MURPHY***

I am readily familiar with the firm's practice of collection and processing
correspondence for mailing. Under that practice it would be deposited with the U.S. Postal
Service on that same day with postage thereon fully prepaid in the ordinary course of business.
I am aware that on motion of the party served, service is presumed invalid if postal cancellation
date or postage meter date is more than one day after date of deposit for mailing in affidavit.

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1 I declare that I am employed in the office of a member of the bar of this court at whose
2 direction the service was made. Executed on **September 14, 2005**, at San Diego, California.

3 
4 _____

Leslie D. Sharpe

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