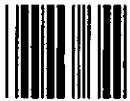


USDC SCAN INDEX SHEET



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

\*20\*

\*RPLY.\*



1 Pursuant to Paragraph XVIII of the Court's November 16, 2004 Temporary  
2 Restraining Order ("TRO"), Defendants submit the following Reply to the  
3 Supplemental Brief Supporting Entry of Preliminary Injunction and Appointment  
4 of a Permanent Receiver ("Supplemental Brief") filed by Plaintiff, the Securities  
5 and Exchange Commission ("SEC").

6 I.

7 **INTRODUCTION**

8 On November 16, 2004, the Court granted the SEC's Application for TRO.  
9 During oral argument on the SEC's Application for TRO, the parties and the Court  
10 addressed the breadth of the SEC's request. The SEC represented to the Court that  
11 it possessed no evidence of wrong-doing with respect to certain non-defendant  
12 entities, and that despite the broad wording of its proposed TRO, the SEC did not  
13 seek to enjoin these non-defendant entities. Notwithstanding the SEC's  
14 representations, on his first day at the Defendants' premises, the Receiver  
15 (recommended by the SEC) sought to obtain the books and records of these non-  
16 defendant entities. Defendants refused to provide the Receiver with access to these  
17 entities, and the SEC now contends that these entities are Defendants' "affiliates,"  
18 and therefore the Receiver should be given access to and control over these entities.  
19 However, the SEC has failed to establish any need for access to these entities, or  
20 that these entities meet the definition of "affiliate."

21 The SEC obtained the TRO based on a faulty financial analysis of  
22 Defendants' books and records. The many problems found in the SEC's analysis  
23 are detailed in Defendants' Opposition to Application for Preliminary Injunction  
24 and the supporting Declaration of J. Stephen Hawkins, filed November 24, 2004.  
25 In its Supplemental Brief, the SEC submits new "evidence," but this new  
26 submission simply perpetuates the accounting mistakes made in the SEC's initial  
27 submission to the Court. The SEC's accounting mistakes constitute the foundation  
28 of their claim and are therefore fatal to it. Accordingly, the SEC's Supplemental

1 Brief, like the SEC's initial application, fails to suggest any threat of ongoing  
2 securities violations, and therefore fails to support the issuance of a preliminary  
3 injunction and the appointment of a permanent receiver.

4 II.

5 **DEFENDANTS HAVE NOT VIOLATED THE TRO—THE SEC'S**  
6 **ATTEMPT TO BOOTSTRAP "AFFILIATES" INTO**  
7 **THE TRO IS IMPROPER**

8 The SEC alleges that Defendants have violated the TRO by refusing to give  
9 the Receiver access to and control over certain entities that the SEC contends fit  
10 within the definition of "affiliates," which was undefined in the SEC's Application  
11 and the resultant TRO. The SEC and the Receiver should not be granted access to  
12 these entities for at least two reasons. First, the SEC's interpretation of the TRO  
13 would effectively shut down seven Non-defendant Entities<sup>1</sup> that are not only *not*  
14 named in the Complaint, but also were expressly disclaimed by the SEC in its oral  
15 argument at the TRO hearing. Second, these entities are not under common control  
16 with Defendants, and therefore do *not* meet the definition of "affiliate."

17 **A. The SEC's Request Would Unjustifiably Harm Seven Non-Defendant**  
18 **Entities.**

19 The TRO appoints a receiver with "full powers of an equity receiver,  
20 including (but not limited to) full power of all funds, assets, collateral, premises  
21 (whether owned, leased, occupied, or otherwise controlled), choses in action,  
22 books, records, papers, and other real or personal property, including notes, deeds  
23 of trust, and other interests in real property...." *TRO*, 4:20-23. The TRO entirely  
24 removes current management from Defendants, and turns all corporate control over  
25

26 <sup>1</sup> The SEC has requested that the Receiver be given access to and control over the following  
27 entities: Emerald Bay Financial, Inc.; Emerald Bay Funding, Inc.; Emerald Bay Financial of  
28 Southern California, Inc.; Unified Mortgage Service, Inc.; CAN Foreclosure Services, Inc.;  
TriStar; and Heritage. These entities will be referred to herein as "the Non-defendant Entities."  
Unified Mortgage Service, Inc., is represented by separate counsel.

1 to the Receiver. Thus, the TRO effectively operates as a shut-down order because  
2 it puts a receiver, inexperienced in the relevant industry and unable to manage the  
3 business on a daily basis (the Receiver is located in Los Angeles County), in the  
4 place of proven management. The SEC now seeks to have management removed in  
5 a similar fashion from seven companies that are *not* defendants.

6 The impropriety of the SEC's request for control over the Non-defendant  
7 Entities can be inferred from the fact it was *not* mentioned in the SEC's Application  
8 for TRO. In fact, during oral argument at the TRO hearing, counsel for the SEC  
9 expressly stated that the SEC does *not* possess evidence of any wrong doing by the  
10 Non-defendant Entities, and that the SEC had not investigated any entities other  
11 than the Defendants. In fact, it is for precisely this reason that the Court limited the  
12 TRO's asset-freeze provisions to the Fund and Emvest, Inc.<sup>2</sup>

13 Notwithstanding the SEC's Application and its representations to the Court,  
14 one of the first acts undertaken by the Receiver was to attempt to gain access to and  
15 control over the seven Non-defendant Entities, which are companies not named in  
16 the Complaint or mentioned in the SEC's Application. Without any allegation of  
17 wrong doing,<sup>3</sup> the SEC and the Receiver seek to remove these entities' rightful  
18 management for the duration of this case. Such a result would do irreparable harm  
19 to these businesses and would be grossly unfair.

20 The SEC argues that the Receiver needs access to the books and records of  
21 the seven Non-defendant Entities in order to properly trace money transferred from  
22 the Defendants to these "affiliates," and that without access to these records, the  
23 Receiver's efforts to determine whether Defendants have improperly funneled  
24 funds through these entities will be hindered. *Pl. Supp. Brief*, 1:14-17, 6:1-4.

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25  
26 <sup>2</sup> The TRO provides that "This Order shall not be construed as an all-encompassing 'asset freeze,'  
but rather prohibits only distributions made to investors from fund assets...." *TRO*, 4:1-2.

27 <sup>3</sup> Indeed, the SEC makes no claim that new information has arisen since its Application for TRO  
28 that would suggest wrong doing at these companies.

1 However, the SEC fails to explain why a receiver is necessary, as opposed to the  
2 less invasive option of the SEC simply issuing a document subpoena. Moreover,  
3 the SEC fails to identify a single questionable transfer or otherwise support its  
4 argument that it needs access to these records. Rather, the SEC baselessly claims  
5 that Defendants' unwillingness to walk away from its non-defendant businesses  
6 suggests "they have something to hide." *Pl. Supp. Brief*, 6:1. Yet the SEC, after  
7 months of investigation and after a week in control of Defendants (by way of the  
8 Receiver), offers *no evidence* of any suspicious transactions that need to be traced.  
9 Additionally, the SEC fails to explain how the treatment of these disbursements by  
10 the recipients is in any way relevant. The SEC has had unfettered access to the  
11 financial records and other documents related to Defendants. The issue at hand is  
12 whether the *Fund's* distributions were appropriate; how the recipient classified the  
13 money received has no bearing on whether the distribution violated securities laws.

14 Appointment of a receiver over the Non-defendant Entities without even a  
15 *prima facie* showing of a violation of securities laws is particularly inappropriate in  
16 light of the draconian nature of the remedy. Although district courts have broad  
17 discretion in appointing receivers, this remedy should be sparingly invoked. See  
18 *SEC v. Wencke*, 622 F.2d 1363, 1369 (9th Cir., 1980). *Lopez v. Medford*  
19 *Community Center, Inc.*, 384 Mass. 163 (Mass., 1981). The power to appoint  
20 receivers "should be sparingly exercised, and with great caution and  
21 circumspection." *Miller v. Fisco, Inc.* 376 F. Supp. 468 (D. Pa., 1974). "The law is  
22 also well established that [appointment of receivers] is a harsh one, one to which a  
23 Court should not resort in any but the most extreme circumstances.." *Tanzer v.*  
24 *Huffines*, 287 F. Supp. 273,274 (D. Del., 1968).

25 Considering the lack of support and the drastic nature of appointing a  
26 receiver, the SEC's request for an unfettered fishing expedition should be denied.

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1 **B. The Companies The SEC Seeks To Enjoin Are Not Under Common**  
2 **“Control” With Defendants, And Therefore Are Not “Affiliates.”**

3 The SEC’s Application and the resultant TRO are silent as to the definition  
4 of “affiliate.” The SEC submits that one particular statutory definition, contained in  
5 the Securities Act of 1933 (the “Securities Act”), applies, and that the Non-  
6 defendant Entities meet this definition. The SEC also cites to Black’s Law  
7 Dictionary. However, the SEC glosses over the fact that both of these definitions  
8 incorporate a key required element—*control*. The SEC goes to great lengths to  
9 show that the Defendants and their previous accountants have in the past referred to  
10 these entities as “affiliates.” However, the SEC fails to show that these entities  
11 meet the non-accounting, non-marketing, *legal* definition of “affiliate,” i.e., that  
12 there is common control.

13 As the SEC points out, Rule 405 of the Securities Act defines an affiliate as  
14 “a person that directly, or indirectly through one or more intermediaries, controls or  
15 is controlled by, *or is under common control* with, the person specified.” *Pl.*  
16 *Suppl. Brief*, 2:28-3:3, quoting 17 C.F.R. §230.405 (emphasis supplied in *Pl. Suppl.*  
17 *Brief*). Black’s Law Dictionary’s definition of “affiliate” also includes the notion  
18 of “control.” *See, Pl. Suppl. Brief*, 3:3-5.

19 The SEC cites the Non-defendant Entities’ “common ownership and  
20 management” as the basis for concluding that these entities are under common  
21 control. However, common ownership does not equal “control.” Rule 405 of the  
22 Securities Act defines “control” as the “possession, direct or indirect, of the power  
23 to direct or cause the direction of the management and policies of a person, whether  
24 through the ownership of voting securities, by contract, or otherwise.” 17 C.F.R.  
25 §230.405. Thus, a determination of whether an entity is an “affiliate” requires more  
26 analysis than simply whether common ownership exists. The question of whether  
27 entities are under “common control,” and therefore “affiliates” of Defendants, is  
28 determined by whether the Defendants (i.e., the Fund, Emvest, Inc, or Brock)

1 possess the “power to direct or cause the direction of the management and policies”  
2 of the Non-defendant Entities. If not, the Non-defendant Entities are not affiliates,  
3 irrespective of whether those entities share common ownership with the  
4 Defendants.

5 After more than seven months of investigation, the SEC has been unable to  
6 submit any evidence that the Non-defendant Entities are “controlled” by the  
7 Defendant entities. Furthermore, with the exception of Brock’s interests in CNA  
8 Foreclosure Services, Inc., none of the Defendants possess sufficient ownership to  
9 exercise “control,” as that term is defined in the Securities Act, over the Non-  
10 defendant Entities. *Brock Decl.*, ¶¶ 3-4. Therefore, CNA is the only Non-  
11 defendant Entity that suffices to meet the definition of “affiliate,” as that term is  
12 defined in the Securities Act or Black’s Law Dictionary.

13 It is true that the Fund’s financial statements and some of its marketing  
14 literature refer to the Non-defendant Entities as affiliates. However, there is no  
15 evidence that the Fund’s accountants or its marketing people intended to invoke the  
16 legal meaning of the term, as opposed to the more commonly-used Webster’s  
17 definition,<sup>4</sup> which does not take into consideration the notion of control. Moreover,  
18 the SEC has failed to provide any authority for the proposition that a term used in  
19 financial statements or marketing literature suffices to satisfy a statutory definition.  
20 Despite the SEC’s rhetoric and unsupported allegations, the Non-defendant Entities  
21 do *not* meet the definition of “affiliate,” and as such, the SEC should not be  
22 permitted to bootstrap the Non-defendant Entities into the TRO.<sup>5</sup>

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24  
25 <sup>4</sup> Webster’s defines an “affiliate” as someone who is connected or associated with another.  
*Webster’s New World Dictionary*, Third College Edition, 1988.

26  
27 <sup>5</sup> As noted above, the SEC’s allegations do not support the appointment of a receiver over any of  
28 Defendants’ affiliates. However, considering Brock’s ownership in CNA, if the Court finds that  
the SEC is entitled to a turn-over of CNA’s books and records, Brock is willing to do so  
immediately upon entry of such an order.

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III.

**THE DEFENDANTS HAVE NOT ENGAGED IN A FRAUDULENT  
SCHEME, AND THEREFORE THERE IS NO REASONABLE  
LIKELIHOOD OF FUTURE SECURITIES LAWS VIOLATIONS**

The SEC contends that Defendants have engaged in continued misconduct by making distributions to investors in November and by allowing new investors into the Fund. Both of these contentions are unfounded. The SEC's new calculations of profits and losses are still based on the unreliable cash receipts and disbursements method of accounting, as opposed to the more accurate accrual method of accounting. Moreover, any actions by the Fund during the months of September, October, and November predate the issuance of the TRO on November 16, 2004, and as such cannot support the SEC's proposition that the defendants will "will likely resume their misconduct and commit future violations."

The SEC cites *SEC v. Murphy* for the proposition that without a receiver in place, Defendants will likely resume their misconduct and commit future violations. *Pl.'s Supp. Brief.* at 6:14-18 citing *Murphy* at 626 F.2d 633, 655 (9<sup>th</sup> Cir. 1980). *Murphy* mandates that the SEC must establish "a reasonable likelihood of future violations of the securities laws." *Id.* But *Murphy* and its progeny also dictate that "in predicting the likelihood of future violations, a court must assess the totality of the circumstances surrounding the defendant and his violations. *Id.* citing *SEC v. Koracorp Industries, Inc.*, 575 F.2d 692, 697-98 (9<sup>th</sup> Cir.), cert. denied sub nom. *Helfat v. SEC*, 439 U.S. 953, (1978). To properly evaluate the totality of the circumstances, courts should consider factors such as

the degree of scienter involved; the isolated or recurrent nature of the infraction; the defendant's recognition of the wrongful nature of his conduct; the likelihood, because of defendant's professional occupation, that future violations might occur; and the sincerity of his assurances against future violations.

*Id.*

1 The SEC has not considered the totality of the circumstances in making its  
2 allegation that Defendants pose a threat of future misconduct—the SEC bases its  
3 argument on specious reasoning and flawed facts. As such, the SEC cannot meet  
4 its burden to show that a preliminary injunction should issue or that the  
5 appointment of a permanent receiver is warranted.

6 **A. The SEC Continues To Base Its Arguments On Inaccurate Accounting.**

7 The SEC’s first allegation that the Fund used another \$102,173.70 of  
8 investor capital to pay returns to investors is flawed because the accounting  
9 methods used to calculate these figures are based on the cash receipts and  
10 disbursements method and not the accrual method of accounting. *See generally,*  
11 *Defendant’s Opposition.* The Fund was not diluting investor capital because it was  
12 not operating at a loss. *Id.*

13 **B. The Fund’s Continued Receipt Of Investments Was Proper And In**  
14 **Keeping With Fiduciary Obligations.**

15 The SEC’s further alleges that the Fund continued to accept new investors  
16 after August 16, 2004 and that by doing so, the Fund engaged in “intentional  
17 misconduct” or, “at a minimum,” poorly managed the Fund. *Pl.’s Supp. Brief. at*  
18 *7:9-18.* Although the Fund did deposit checks after August 16, 2004, it did so in  
19 order to honor transactions initiated before or during the month of August and, in  
20 any event, *substantially* before the November 16, 2004 TRO. *Brock Decl. ¶ 5.*  
21 As a manager of the Fund, Emvest, Inc. (and its CEO, Brock) owes a duty to the  
22 Fund to honor transactions initiated before the SEC’s intervention. The Fund  
23 accepted and deposited a total of ten (10) checks in August, September, and  
24 October of 2004. *Brock Decl. ¶ 5.* However, each transaction that was actually

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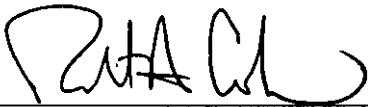


1 reasons, the SEC's application for a preliminary injunction and appointment of a  
2 permanent receiver should be denied.

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Dated: November 30, 2004

MCKENNA LONG & ALDRIDGE LLP

By: 

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

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,  
6 California. I am over the age of eighteen years and not a party to the within-entitled  
7 action. My business address is Suite 3300, Symphony Towers, 750 B Street, San  
8 Diego, California 92101. On **November 30, 2004**, I served a copy of the within  
9 document(s):

- 10 • **DEFENDANTS' REPLY TO PLAINTIFF'S SUPPLEMENTAL**  
11 **BRIEF SUPPORTING ENTRY OF PRELIMINARY**  
12 **INJUNCTION AND APPOINTMENT OF A PERMANENT**  
13 **RECEIVER**
- 14 • **DECLARATION OF MILON LYLE BROCK IN SUPPORT OF**  
15 **DEFENDANTS' REPLY TO PLAINTIFF'S SUPPLEMENTAL**  
16 **BRIEF SUPPORTING ENTRY OF PRELIMINARY**  
17 **INJUNCTION AND APPOINTMENT OF PERMANENT**  
18 **RECEIVER**

- 19  by transmitting via facsimile the document(s) listed above to the fax  
20 number(s) set forth below on this date before 5:00 p.m.
- 21  by placing the document(s) listed above in a sealed envelope with  
22 postage thereon fully prepaid, in the United States mail at San Diego,  
23 California addressed as set forth below.
- 24  by placing the document(s) listed above in a sealed \_\_\_\_\_  
25 envelope and affixing a pre-paid air bill, and causing the envelope to  
26 be delivered to a \_\_\_\_\_ agent for delivery.
- 27  by personally delivering the document(s) listed above to the  
28 person(s) at the address(es) set forth below.

24 *Attorneys for Plaintiff Securities*  
25 *Exchange Commission*

*Molly M. White, Esq.*  
*Kelly Bowers, Esq.*  
*Victoria A. Levin, Esq.*  
*Susan F. Hannan, Esq.*  
*Securities and Exchange Commission*  
*5670 Wilshire Boulevard, 11<sup>th</sup> Floor*  
*Los Angeles, CA 90036*  
*Phone: (323) 965-3998 / Fax (323) 965-3908*

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

7 I declare that I am employed in the office of a member of the bar of this court  
8 at whose direction the service was made.

9 Executed on **November 30, 2004**, at San Diego, California.

10   
11 \_\_\_\_\_  
12 Leslie D. Sharpe

13 SD:22131512.1

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