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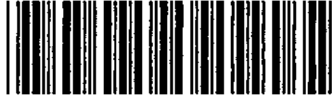

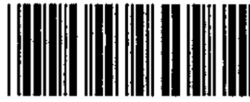

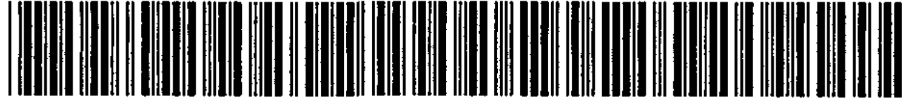

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RPLY.

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CLERK, U.S. DISTRICT COURT SOUTHERN DISTRICT OF CALIFORNIA
BY: DEPUTY

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF CALIFORNIA

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

v.

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

Defendants.

CASE NO. 04 CV 2295 DMS (POR)

DEFENDANTS' REPLY TO PLAINTIFF'S OPPOSITION TO DEFENDANTS' MOTION FOR RECONSIDERATION OF THE COURT'S DECEMBER 16, 2005 ORDER: (1) DENYING DEFENDANTS' MOTION FOR SUMMARY JUDGMENT; AND (2) GRANTING-IN-PART AND DENYING-IN-PART PLAINTIFF'S CROSS-MOTION FOR SUMMARY JUDGMENT

Trial: January 3, 2006
Time: 9:00 a.m.
Ctrm: 10

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I. INTRODUCTION

The SEC claims in its Opposition that Defendants' Motion for Reconsideration should be denied because: 1) defense counsel did not file a certified statement pursuant to the Local Rules of Court; 2) the Court correctly ruled that the Prospectus and its Summary are inconsistent in describing the 12% distribution at issue in this case; and 3) the Court correctly ruled that a reasonable investor with Emvest Mortgage Fund, LLC (the "Fund") would have given weight to advertisements and other documents that were not included within Offering Materials, even though the Offering Materials said not to do so.

The Court should reject these arguments. First, Local Rule 7.1 (i)(1) does not apply to the Motion for Reconsideration in this case because Defendants are not seeking reconsideration based on new facts or circumstances that require verification under oath. Rather, Defendants are respectfully seeking reconsideration because the Court committed clear error based on its interpretation of facts already presented by the parties in connection with the SEC's Motion for Summary Judgment.

Second, the Prospectus and its Summary are consistent regarding the 12% distribution. The Summary states the 12% distribution would be based on the investors' "unreturned original invested capital," which contemplates that some distributions could include original (i.e., returned) capital. This is short form for the phrase "as reduced by cumulative Priority Operating Return Distributions to Shareholders," which is stated in the body of the Prospectus. In its Opposition, the SEC argues that the only interpretation of the Summary's phrase, "unreturned original invested capital," is the investor would be paid 12% per year on the original invested capital that the investor did not ask the Fund to return. SEC's Opposition at 4:3-11. But under a literal reading of "unreturned", the Fund could return originally invested capital as part of the 12% distribution. In the final analysis, the minor differences between the language in the Prospectus and its Summary does not amount to a material inconsistency. There was no misrepresentation, and thus, the Court should not have granted summary judgment on this claim.

Further, the Court incorrectly interpreted and applied *Basic v. Levinson*, 485 U.S. 224, 231-32 (1988) in finding that a reasonable investor would have considered advertisements and

other documents outside the Offering Materials to be material, despite a clear warning in the Prospectus that no representations outside the Offering Materials were authorized or reliable. This raises an issue of first impression for the Ninth Circuit, but there is persuasive authority from other Circuits that explain why the Court should have limited its analysis to the Offering Materials. Had the Court done so, it would not have found misrepresentation. The SEC argues that the disclaimer was insufficient by suggesting it was "buried somewhere" in the Offering Materials. But this is another example of the SEC's tortured reading of the relevant documents – the SEC knows full well that the disclaimer was placed front and center in ALL CAPS on the inside cover of the Prospectuses.

Defendants have shown that the Court's ruling regarding the 12% distribution constitutes clear error. The SEC's Opposition fails to show otherwise. Therefore, Defendants' Motion for Reconsideration should be granted.

II. THERE IS A SUFFICIENT BASIS FOR THE COURT TO RECONSIDER ITS RULING

Although the SEC claims there is no basis for Defendants' Motion for Reconsideration, the authorities it cites stand for the proposition that "clear error" or "manifest injustice" is one of the three grounds for reconsideration. SEC's Opposition at 1:23-2:1 (*citing United States v. James*, 915 F. Supp. 1092, 1098 (S.D. Cal. 1995) and *School Dist. No. 1J, Multinomah County v. ACandS, Inc.*, 5 F.3d 1255, 1263 (9th Cir. 1993). In their moving papers, Defendants explained why they respectfully believed the Court's Order constituted clear error and would result in manifest injustice.

The SEC also claims the Court should deny the Motion for Reconsideration because defense counsel did not submit a certified statement pursuant to Local Civil Rule 7.1(i)(1). That Rule requires, *inter alia*, that the statement include: "(1) when and to what judge the application was made, (2) what ruling or decision or order was made thereon, and (3) what new or different facts and circumstances are claimed to exist which did not exist, or were not shown, upon such prior application." Civ. L.R. 7.1(i)(1).

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A certified statement is unnecessary in this case given the nature of the Motion for Reconsideration and the fact that it was filed with the same judge who heard the original cross-Motions for Summary Judgment within five days of the issuance of the Court's Order. First, the Court obviously knows when and to what judge the original motion was offered. Second, the Court is well aware of what ruling was made thereon. Third, the Motion for Reconsideration does not rely upon new and/or different facts and circumstances, but is based instead on an argument that the Court's Order constituted clear error and would result in manifest injustice. Accordingly, Local Civil Rule 7.1(i)(1) should not preclude the Court from considering Defendants' Motion for Reconsideration.

III. THE LANGUAGE OF THE PROSPECTUS SUMMARY WAS NOT MISLEADING

In its Order, the Court found Defendants misrepresented the 12% distribution because the Prospectus Summary and body of the Prospectus contained "contradictory" language regarding the 12% distribution. *See* Order at 9:22-10:7. In their moving papers, Defendants demonstrated that the Court's ruling constituted clear error. First, the language of the Prospectus Summary was not contradictory to the more detailed information found in the body of the Prospectus because the Summary utilized the phrase "unreturned original invested capital"[1] as short form for the longer phrase "as reduced by cumulative Priority Operating Return Distributions to the Shareholders."[2] Second, the Summary expressly warned potential investors of its inherent limitations and of the need to carefully review the entire Prospectus.

The SEC's Opposition is not persuasive. It relies on arguments it made in support of the preliminary injunction by claiming that the "quoted language [in the Summary] simply told investors that they would be paid 12% per year on the original invested capital that the investor *did not ask the Fund to return.*" While that may be the SEC's preferred interpretation of

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[1] 2002 Prospectus Summary at 1, Exh. 6 of Defendants' Motion for Summary Judgment, Docket No. 161 (emphasis added). Unless otherwise indicated, the language for the cited Prospectus is the same as the other Prospectuses at issue in this case.

[2] 2002 Prospectus at 11.

“unreturned original invested capital,” it is not correct. A literal reading of the phrase cautions that the Fund could return originally invested capital as part of the 12% distribution, not that original capital could be returned at the request of the investor. This is consistent with the language in the body of the Prospectus which states that investors were entitled to a 12% priority return on their invested capital, as reduced by cumulative Priority Operating Return Distributions to Shareholders. 2002 Prospectus at 11. For purposes of evaluating the SEC's motion for summary judgment on this claim, all reasonable inferences regarding the language in the Prospectus and its Summary must be drawn in favor of the Defendants. *T.W. Elec. Serv., Inc. v. Pac. Elec. Contractors Ass'n*, 809 F.2d 626, 630-31 (9th Cir. 1987); *Stansifer v. Chrysler Motors Corp.*, 487 F.2d 59, 63 (9th Cir. 1973). The SEC has failed to prove why its interpretation of those documents amounts to an inconsistency, and thus, it was clear error for the Court to find that one exists.

IV. NO REASONABLE INVESTOR COULD HAVE CONSIDERED THE ADVERTISEMENTS, NEWSLETTERS, AND/OR SALES PERSONS' STATEMENTS TO BE IMPORTANT TO THEIR INVESTMENT DECISION IN LIGHT OF THE EXPRESS WARNINGS CONTAINED IN THE OFFERING MATERIALS

The SEC claims that: (1) a clear statement in the Prospectus, that only the representations in the Offering Materials are authorized and may be relied upon, is of no significance because the SEC does not have to establish the element of reliance; and (2) the warning language of the Prospectus was insufficient because it was “buried” in the Offering Materials. These arguments miss the mark because: (a) no reasonable investor would consider statements made outside of the Offering Materials to be important (i.e., material) to their investment decision when he was informed in writing that such materials were not to be used in making his investment decision; and (b) such cautionary language was impossible to miss, given that it appeared in ALL CAPITALS on the inside cover of the Prospectuses.

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A. No Reasonable Investor Would Consider To Be Important Any Information That He Was Told Could Not Be Relied Upon In Reaching An Investment Decision

3 The issue raised by Defendants appears to be one of first impression in the Ninth Circuit,
4 and is perfectly consistent with the United States Supreme Court's definition of "materiality." In
5 *Basic, Inc. v. Levinson*, 485 U.S. 224, 240 (1988), the Supreme Court held that "materiality
6 depends on the significance the reasonable investor would place on the withheld or
7 misrepresented information." In other words, in order for misrepresented or omitted facts to be
8 material, there must be a substantial likelihood that a reasonable shareholder would consider them
9 important in making their investment decision. *Id.* at 231.

10 Here, the SEC contends that the advertisements, newsletters, and/or statements of
11 salespersons misrepresented that the 12% distribution would come only from profits. Yet, in light
12 of the undisputed fact that the Offering Materials expressly informed investors that
13 advertisements or any other statements not contained in the Offering Materials could not be relied
14 upon in reaching an investment decision, no <u>reasonable</u> investor could have considered the
15 advertisements, newsletters, or salesperson's statements to have been "important" to their
16 investment decision.[3]

17 In order to adopt the SEC's position, the Court would have to presume that a reasonable
18 investor is not capable of following directions and excluding from his or her investment decision,
19 information outside of the Offering Materials. As noted by the Supreme Court, however, the
20 "role of the materiality requirement is not to 'attribute to investors a child-like simplicity, the
21 inability to grasp the probabilistic significance of negotiations,' but to filter out essentially useless
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[3] *See, e.g.*, 2002 Prospectus at i. In *Basic*, the Supreme Court was faced with "the narrow question of whether information concerning the existence and status of preliminary merger discussions is significant to the reasonable investor's trading decision." *Basic*, 485 U.S. at 235. In the instant case, the Court is faced with the narrow question of whether information outside of the Offering Materials could have been significant to a reasonable investor's decision of whether or not to invest in the Fund in light of the express language advising potential investors that no such information could be used in reaching their investment decision.

The clarity of the disclaimer in the Prospectuses as to the use of any information outside of the Offering Materials is discussed in the next section of this Reply.

information that a reasonable investor would not consider significant, even as part of a larger 'mix' of factors to consider in making his investment decision." *Id.* at 234, *citing TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 448-49 (1976). A reasonable investor cannot be presumed to be someone who placed significance on information he or she was told should not be considered as part of their investment decision. Yet, this is precisely what the SEC has invited the Court to presume.

The SEC also contends that *Porter v. Shearson Lehman Bros., Inc.*, 802 F. Supp. 41 (S.D. Tex. 1992), should be ignored because it was a private action involving the reasonableness of the private plaintiffs' reliance. SEC's Opposition at 6:21-24. While it is true that the court's focus in *Porter* was reasonable reliance, it is persuasive here because the *Porter* court recognized the viability of express warnings in the offering materials that information not contained therein could not be relied upon. Given that such information could not be relied upon as a matter of law, it also could not have been deemed material (i.e., important to their investment decision) by a reasonable investor. Thus, by extension, *Porter* provides support for the unremarkable proposition that a reasonable investor would not place significance on materials that he or she was told were not to be relied upon in reaching an investment decision.[4]

Finally, the SEC cites *In re Convergent Techs. Sec. Litig.*, 948 F.2d 507, 512 (9th Cir. 1991), for the proposition that the Court should look beyond the written Offering Materials even if a reasonable investor's investment decision was expressly limited to such materials. SEC's Opposition at 7:12-22. *Convergent* is distinguishable because it did not address the type of cautionary language contained in the Offering Materials at issue here – specifically, that potential investors were advised that their investment decision should be confined to the contents of the Offering Materials and that advertisements or other alleged representations could not be relied

[4] The SEC further contends that Porter should not be given credence because it was decided by the United States District Court for the Southern District of Texas. However, the Ninth Circuit has not considered the issue decided by *Porter*, and *Porter* relied upon a Tenth Circuit decision that also held that it would be unreasonable for an investor to rely upon an alleged misrepresentation outside the offering materials when such materials expressly warned prospective investors that any such information could not be relied upon. *See Porter*, 802 F. Supp. at 58, *citing Zobrist v Coal-X, Inc.*, 708 F.2d 1511, 1518-19 (10th Cir. 1983).

upon. Instead, the *Convergent* court was simply making the point that, in a case in which plaintiff was proceeding under a fraud-on-the-market theory of reliance, the court should consider all information that reached the market because it would have impacted the purchase price of the shares. Thus, *Convergent* is not useful to the Court in answering the question presented in the Motion for Reconsideration.

For the foregoing reasons, the Court should grant the Motion for Reconsideration.

B. The Explicit Language In The Prospectuses, Advising Potential Investors That Any Representations Made Outside The Offering Materials Were Unauthorized And Could Not Be Relied Upon, Was Not "Buried" In The Offering Materials

The SEC claims that any language, advising potential investors that the only representations on which they could base their investment decision were contained solely in the written Offering Materials, should be ignored because such advice was "burie[d] somewhere in [the] offering materials. . . ." SEC's Opposition at 7:19-22. The undisputed facts, however, are to the contrary.

First, the warning that only the contents of the Offering Materials should be considered in making an investment decision was not buried "somewhere" in the Offering Materials. Instead, it was placed front and center and in all capitals on the inside cover of the Prospectuses. *See, e.g.*, 2002 Prospectus at i. There, the following cautionary language appeared:

> OFFERS OF SHARES ARE MADE SOLELY BY MEANS OF THIS PROSPECTUS AND THE ACCOMPANYING MATERIALS REFERRED TO HEREIN, INCLUDING THE OPERATING AGREEMENT AND THE SUBSCRIPTION AGREEMENT. . . . NO OFFERING LITERATURE OR ADVERTISING IN WHATEVER FORM MAY BE RELIED UPON IN THIS OFFERING EXCEPT FOR THE DOCUMENTS REFERRED TO ABOVE.

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Id. (emphasis added). It is hard to imagine how this warning could have been made more conspicuous to a reasonable investor.[5]

Second, the Prospectus cautioned that any representations not contained in the Offering Materials were unauthorized and could not be relied upon. *2002 Prospectus* at 22 ("Except as set forth herein, no person has been authorized to give any information, or to make any representations or warranties, either expressed or implied, concerning the Company or the Shares. If made, such information must not be relied upon.") Thus, the SEC's contention that nothing in the Offering Materials cautioned investors that outside information such as advertisements was not reliable, is simply incorrect.

V. <u>CONCLUSION</u>

For the reasons stated above, Defendants request the Court to grant Defendants' Motion for Reconsideration.

Dated: December 29, 2005

Respectfully submitted,

McKENNA LONG & ALDRIDGE LLP

By: ______________________

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[5] Tellingly, when the SEC quoted this warning in its Opposition, it did so without using all capitals in an effort to downplay the emphasis placed on this language in the Prospectus. SEC's Opposition at 8:3-6. Moreover, while the SEC contends that it was not clear what documents comprised the Offering Materials, the disclaimer informed investors that "NO OFFERING LITERATURE OR ADVERTISING IN WHATEVER FORM MAY BE RELIED UPON IN THIS OFFERING EXCEPT FOR THE DOCUMENTS REFERRED TO ABOVE." 2002 Prospectus at i. The only documents referred to "ABOVE," are the Prospectus, the Operating Agreement and the Subscription Agreement. The SEC bears the burden of proof and all inferences are to be drawn in favor of Defendants as the parties opposing the SEC's Motion for Partial Summary Judgment. *T.W. Elec. Serv., Inc. v. Pac. Elec. Contractors Ass'n*, 809 F.2d 626, 630-31 (9th Cir. 1987); *Stansifer v. Chrysler Motors Corp.*, 487 F.2d 59, 63 (9th Cir. 1973). Yet the SEC has provided <u>no</u> evidence that <u>any</u> other documentation was provided with the "PROSPECTUS AND THE ACCOMPANYING MATERIALS REFERRED TO HEREIN."

Securities and Exchange Commission v. Emvest Mortgage Fund, LLC, et al.
United States District Court Case No. 04CV2295-DMS (POR)

PROOF OF SERVICE

I, Leslie D. Sharpe, declare:

I am a citizen of the United States and employed in San Diego County, California. I am over the age of eighteen years and not a party to the within-entitled action. My business address is Suite 3300, Symphony Towers, 750 B Street, San Diego, California 92101. On **December 29, 2005**, I served a copy of the within document(s):

- **DEFENDANTS' REPLY TO PLAINTIFF'S OPPOSITION TO DEFENDANTS' MOTION FOR RECONSIDERATION OF THE COURT'S DECEMBER 16, 2005 ORDER: (1) DENYING DEFENDANTS' MOTION FOR SUMMARY JUDGMENT; AND (2) GRANTING-IN-PART AND DENYING-IN-PART PLAINTIFF'S CROSS-MOTION FOR SUMMARY JUDGMENT**

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

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

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

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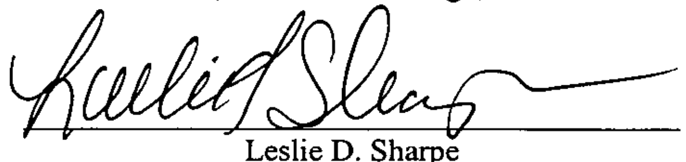
I am readily familiar with the firm's practice of collection and processing correspondence for mailing. Under that practice it would be deposited with the U.S. Postal Service on that same day with postage thereon fully prepaid in the ordinary course of business. I am aware that on motion of the party 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.

I declare that I am employed in the office of a member of the bar of this court at whose direction the service was made. Executed on **December 29, 2005**, at San Diego, California.



Leslie D. Sharpe