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

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SOUTHERN DISTRICT OF CALIFORNIA

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8 **UNITED STATES DISTRICT COURT**
9 **SOUTHERN DISTRICT OF CALIFORNIA**
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11 UNITED STATES SECURITIES AND
12 EXCHANGE COMMISSION,

Plaintiff,

13 vs.

14
15 EMVEST MORTGAGE FUND, LLC,
16 EMVEST, INC., and MILON LYLE
17 BROCK,

Defendants.

CASE NO. 04cv2295-DMS(LSP)

**ORDER RE: DEFENDANTS' *EX*
PARTE APPLICATION FOR
CLARIFICATION**

[Doc. No. 37]

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19
20 By Order dated December 3, 2004, this Court granted Plaintiff SEC's application for
21 a preliminary injunction and appointed Dennis R. Murphy as Permanent Receiver. On
22 December 9, 2004, Defendants Emvest Mortgage Fund, LLC (the "Fund"), Emvest, Inc., and
23 Milon Lyle Brock, submitted an *ex parte* application for clarification of the Court's Order and
24 limiting the powers of the Receiver. Defendants maintain the Receiver has "taken several
25 actions that materially undermine Defendants' ability to defend the instant action, threaten the
26 viability of the Fund, and are contrary to the clear intent of the" preliminary injunction Order.
27 (App. at 1.) The SEC submitted its response on December 16, 2004. The Receiver also
28 submitted his response on December 16, 2004.

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04CV2295

1 I.

2 DISCUSSION

3 In their *ex parte* application, Defendants request several clarifications from the Court:
4 (1) that Defendant Brock—and not the Receiver—is the person in control of defending this
5 action, including the selection and retention of defense counsel; (2) that the Receiver is
6 prohibited from terminating or otherwise affecting the employment of defense counsel; (3) that
7 the Receiver is required to return original documents to Defendants’ premises and is prohibited
8 from interfering with review of such documents by Defendants’ attorneys; (4) that the Receiver
9 must provide defense counsel at least five days notice of any intended actions beyond the scope
10 of the Defendants’ day-to-day business; and (5) that the Receiver shall conduct the day-to-day
11 business of the Fund.

12 1. **Receiverships: General Principles**

13 Before the Court considers the specifics of the *ex parte* application, a few brief
14 comments on receiverships may be helpful. A receiver has been defined as, “A disinterested
15 person appointed by a court . . . for the protection or collection of property that is the subject
16 of diverse claims.” Black’s Law Dictionary, at 1275 (7th ed. 1999). A receivership is an
17 ancillary and incidental remedy; it is a means to reach some legitimate end, rather than an end
18 in itself. *See Pusey & Jones Co. v. Hanssen*, 261 U.S. 491, 497 (1923) (“A receivership is not
19 final relief. The appointment determines no substantive right, nor is it a step in the
20 determination of such a right. It is a means of preserving property”); *Gordon v.*
21 *Washington*, 295 U.S. 30, 37 (1935). The receivership serves the purpose of preserving,
22 liquidating, or operating property, pending final disposition of a case. *Hanssen*, 261 U.S. at
23 497.

24 On proper showing by the SEC, a district court hearing an action brought under the
25 securities laws has the equity power to fashion virtually any type of ancillary relief—including
26 the freeze of a defendant’s assets and the appointment of a receiver. *See S.E.C. v. Manor*
27 *Nursing Ctrs., Inc.*, 482 F.2d 1082, 1105 (2nd Cir. 1972); *S.E.C. v. Hardy*, 803 F.2d 1034,
28 1037–38 (9th Cir. 1986) (describing as “extremely broad” the district court’s power to supervise

1 an equity receivership and to determine the appropriate action to be taken in the administration
2 of the receivership). As stated by the Ninth Circuit: “Unless a statute in so many words, or by
3 a necessary and inescapable inference, restricts the court’s jurisdiction in equity, the full scope
4 of that jurisdiction is to be recognized and applied. ‘The great principles of equity, securing
5 complete justice, should not be yielded to light inferences, or doubtful construction.’” *Reebok*
6 *Int’l, Ltd. v. Marnatech Enters., Inc.*, 970 F.2d 552, 561–62 (9th Cir. 1992) (quoting *Brown v.*
7 *Swann*, 35 U.S. (10 Pet.) 497, 503 (1836)).

8 Nevertheless, a receiver’s powers are not unlimited, and his or her actions are not to be
9 left unmonitored. “Receiverships have at times a legitimate function, but they are to be
10 watched with jealous eyes lest their function be perverted.” *Michigan v. Michigan Trust Co.*,
11 286 U.S. 334, 345 (1932) (opinion of Cardozo, J.). To this end, a court’s inherent equity
12 power affords it a wide degree of latitude in defining the scope of the receivership. *See e.g.*,
13 *S.E.C. v. Wencke*, 622 F.2d 1363, 1369 (9th Cir. 1980); *S.E.C. v. Lincoln Thrift Ass’n*, 577 F.2d
14 600, 609 (9th Cir. 1978). The receiver is at all times an officer of the court. *See In re San*
15 *Vincente Med. Partners, Ltd.*, 962 F.2d 1402, 1409 (9th Cir. 1992). Therefore, although the
16 receiver acts for all interested parties, he is not an agent or an employee of any party to the
17 litigation. *Ledbetter v. Farmers Bank & Trust Co.*, 142 F.2d 147, 150 (4th Cir. 1944);
18 *Resolution Trust Corp. v. Bayside Developers*, 43 F.3d 1230, 1241 n.8 (9th Cir. 1994). With
19 this background, the Court now turns to the issues raised in Defendants’ *ex parte* application.

20 **2. Selection and Retention of Defense Counsel**

21 According to Defendants: “One of Mr. Murphy’s first actions as permanent receiver
22 was to attempt to terminate the engagement of Defendants’ counsel . . . and accounting
23 consultant.” (App. at 2.) Defendants insist that the Receiver’s actions will fatally undermine
24 the Defendants’ ability to defend this case. (App. at 2–3.) The underlying question in this
25 case—whether the Defendants have committed securities fraud—comes down (in large part)
26 to differences in accounting principles. Defendants argue that without their attorneys and own
27 accounting consultant, they will be “prohibited from offering evidence to contradict the SEC’s
28 analysis.” (*Id.* at 3.)

1 In opposition, the SEC responds that on November 15, 2004 (one day before this Court
2 issued the TRO), the Fund wrote a \$150,000 cashier's check to the law firm of McKenna Long
3 & Aldridge LLP (the Defendants' attorneys), in anticipation of the impending TRO. (Opp'n
4 at 3 & n.4.) At the current stage of the proceedings, the Court has already found a *prima facie*
5 case of securities fraud (Defendants were paying out more than they were taking in; thus, any
6 disbursements were being paid out of new investments). Consequently, a presumption exists
7 that the \$150,000 was also taken from the investors' capital, in violation of the securities laws.
8 The SEC correctly points out that defendants in fraud actions are not permitted to use investor
9 funds to pay for their defense. (*Id.* at 3–4.) See *S.E.C. v. Quinn*, 997 F.2d 287, 289 (7th Cir.
10 1993) (“Parties to litigation may usually spend their resources as they please to retain counsel.
11 ‘Their’ resources is a vital qualifier. Just as a bank robber cannot use the loot to wage the best
12 defense money can buy, so a swindler in securities markets cannot use the victim’s assets to
13 hire counsel who will help him retain the gleanings of crime.”) (internal citations omitted).
14 *Cf. Caplin & Drysdale, Chartered v. U.S.*, 491 U.S. 617, 626 (1989) (“A defendant has no
15 . . . right to spend another person’s money for services rendered by an attorney, even if those
16 funds are the only way that a defendant will be able to retain the attorney of his choice.”).

17 In addition, the SEC argues that Defendant Brock is not inhibited from retaining (and
18 paying for) his own counsel, with his own funds, from assets he can demonstrate are not
19 derived from investors' funds. (Opp'n at 5.) According to the SEC, Defendant Brock's
20 personal assets—which are significant—have not been frozen. (*Id.*; Murphy Decl., ¶3 & Ex.
21 2 (showing that Defendant Brock owns a home with an estimated worth of between \$1.5 and
22 \$1.6 million).) As for entity defendants (the Fund and Emvest, Inc.), the Receiver is now
23 deemed the person in control of those entities; he has the ability to determine which attorneys
24 will best represent the interests of the Fund, Emvest, Inc., and the investors. (Opp'n at 5.) The
25 Receiver adds that inherent in the power to control the Defendants' business is the power to
26 “determine which counsel, if any, should represent the Defendants.” (Receiver's Response at
27 2.)

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1 To resolve the instant dispute, the Court must further define the scope of the
2 receivership. Of course, a receiver's role differs from case to case. Here, the SEC has alleged
3 Defendants have been mismanaging the Fund by taking out more money (in distributions to
4 investors) that they are taking in. The Receiver's primary function in this case, therefore, is
5 to prevent any further asset dissipation, until it is determined whether Defendants have actually
6 committed securities fraud. Accordingly, the Court ordered that any further distributions to
7 investors be frozen, and that the Receiver have access to and control of all assets belonging to
8 the Fund or Emvest, Inc.

9 Nonetheless, the Receiver has not been given unlimited powers in relation to the
10 Defendants. Specifically, he does not have the authority to select, retain, or terminate the
11 employment of defense counsel or defendants' experts (accountants), or to determine defense
12 strategy. Such decisions must ultimately rest with the Defendants themselves. As persuasively
13 set forth by Defendants, the SEC effectively looks to convert a motion for a preliminary
14 injunction into a motion for summary judgment. (App. at 2–3.) “Based on this logic, [the
15 Receiver] presumably believes that he is also empowered to settle the SEC's claims or
16 otherwise resolve this litigation, without any checks and balances.” (*Id.* at 4.)

17 Were the Receiver permitted to terminate defense counsel and control the defense
18 strategy, the entity defendants may be precluded from defending themselves. The Receiver
19 seeks to preserve Fund assets for investors; he does not necessarily have the incentive to
20 proceed with the current defense being asserted in this case (that the Fund has not violated the
21 securities laws). He may conclude the investors are best served by reaching a settlement with
22 the SEC (regardless of the Defendants' ultimate liability for securities fraud), rather than risk
23 substantial attorneys fees and incur further penalties. However, this would deprive
24 Defendants' of their fundamental right to test the Government's case and show their own
25 compliance with the securities laws. Thus far, the Court has only found a *prima facie* violation
26 of securities laws. (*See* Preliminary Injunction Order at 15.) Naturally, this is not the full
27 extent of the inquiry—the SEC must still meet its burden to prove an *actual* violation by a
28 preponderance of the evidence, before liability will attach. *See* Black's Law Dictionary, 1209

1 (7th ed. 1999) (defining *prima facie* as: “At first sight; on first appearance but subject to further
2 evidence or information”). At this point, it remains entirely possible that “further evidence or
3 information” may come to light, and that the SEC may ultimately be unable to meet its burden.
4 Permitting the Receiver to terminate defense counsel (and control the defense strategy) at this
5 stage of the litigation risks unjustifiably lifting this weight from the SEC’s shoulders.

6 While this is not a criminal action, the SEC does seek civil penalties under the securities
7 laws; this case is of a quasi-criminal nature. In such a case, however, no Sixth Amendment
8 right to appointed counsel attaches because this remains a *civil* action; the Sixth Amendment
9 applies only to *criminal* cases. (Opp’n at 5–6 (“There is no constitutional right to a defense
10 in a civil action.”).) See *U.S. v. \$29,888.04*, 54 F.3d 564, 569 (9th Cir. 1995). Nonetheless,
11 Defendants are not seeking *appointed* counsel. Rather, they simply want to be in control of
12 their own defense. This concern implicates the Fifth Amendment’s guarantee of due process,
13 which applies forcefully in the quasi-criminal arena. See *U.S. v. Marolf*, 173 F.3d 1213, 1217
14 (9th Cir. 1999) (“we are ‘particularly wary of civil forfeiture statutes, for they impose ‘quasi
15 criminal’ penalties without affording property owners all of the procedural protections afforded
16 criminal defendants.’”) (quotation omitted).

17 When the great machinery of the United States Government comes to bear upon
18 individual defendants, the courts often function as the citizens’ only buffer. See *The Federalist*
19 No. 78 (Alexander Hamilton) (“the courts were designed to be an intermediate body between
20 the people and the legislature, in order, among other things, to keep the latter within the limits
21 assigned to their authority.”). Cf. *Caplin & Drysdale*, 491 U.S. at 635 (“it is unseemly and
22 unjust for the Government to beggar those it prosecutes in order to disable their defense at
23 trial.”) (Blackmun, J., dissenting). The integrity of the judicial process demands that when the
24 Government brings a quasi-criminal action against one of its citizens, the defendant must be
25 permitted to obtain defense counsel of his own choosing, and to chart his own defense strategy,
26 without unwarranted interference from this Court or the Government. Cf. *id.* at 648 (“our
27 chosen system of . . . justice is built upon a truly equal and adversarial presentation of the case,
28 and upon the trust that can exist only when counsel is truly independent of the Government.

1 Without the right, reasonably exercised, to counsel of choice, the effectiveness of that system
2 is imperiled.”) (Blackmun, J., dissenting). To hold otherwise would offend this Court’s
3 notions of fundamental fairness and procedural due process. *See Joint Anti-Fascist Refugee*
4 *Comm. v. McGrath*, 341 U.S. 123, 170 (1951) (“democracy implies respect for the elementary
5 rights of men, however suspect or unworthy; a democratic government must therefore practice
6 fairness.”) (Frankfurter, J., concurring).¹

7 Nonetheless, this Court’s holding comes with an important caveat: Defendants may not
8 further expend the Fund’s assets on their defense. *See e.g., Quinn*, 997 F.2d at 289. The
9 caselaw is “anything but consistent on whether defendants in this type of civil enforcement
10 action may be permitted to pay attorney’s fees with a portion of their frozen assets.” *S.E.C.*
11 *v. Dowdell*, 175 F. Supp. 2d 850, 855 (D. W.Va. 2001) (permitting reasonable attorney’s fees
12 to be expended from the frozen assets, taking defendants through the preliminary injunction
13 stage). *Compare S.E.C. v. Duclaud Gonzalez de Castilla*, 170 F. Supp. 2d 427, 429–30
14 (S.D.N.Y. 2001) (modifying the asset freeze to provide for legal fees, where defendants had
15 presented a possible meritorious challenge to the SEC’s evidence), *with S.E.C. v. Coates*, No.
16 94 Civ. 5361(KMW), 1994 WL 455558, at *3 (S.D.N.Y. Aug. 23, 1994) (“A defendant is not
17 entitled to foot his legal bill with funds that are tainted by fraud.”). This Court, however,
18 having already found a *prima facie* violation of the securities laws, has concern for further
19 depletion of investors’ funds. Moreover, Defendant Brock evidently has sufficient assets to
20 continue the retention of defense counsel and accounting experts. Therefore, while the
21 Defendants (and not the Receiver) remain in control of selecting and retaining defense counsel,

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25 ¹ The SEC raises several ethical issues regarding the Defendant’s continued retention of their chosen
26 counsel. Specifically, the SEC argues the Receiver now controls the attorney-client privilege on behalf of the
27 Fund and Emvest, Inc. (Opp’n at 5.) According to the SEC, if the same counsel represents both Defendant
28 Brock and the entity defendants, the Receiver may access all of that counsel’s privileged information regarding
this case—even that which pertains solely to Defendant Brock. (*Id.*) The SEC also contends that Defendant
Brock’s interests may no longer be aligned with the entity defendants, suggesting a possible conflict problem.
(*Id.*) The SEC’s ethical concerns, while important, are at this point speculative. The Court will defer ruling
on any privilege or conflict issues until (or unless) an actual dispute arises.

1 and possess the ultimate authority to chart the defense strategy in this case, the attorney's fees
2 are not to be paid out of the Fund's assets.²

3 **3. Removal of Original Documents**

4 Next, Defendants complain that on December 8, 2004, the Receiver removed several
5 boxes of original documents from Defendants' premises (in San Diego), and took the boxes
6 back to his office (in Pasadena). Defendants insist that these documents are urgently needed
7 to prepare a defense. (App. at 2.) The SEC responds that the Court's Preliminary Injunction
8 Order specifically provide the Receiver with the power to "access and to take custody of all
9 . . . books, records, papers, and other real property, including notes, deeds of trust, and other
10 interest in real property" of the Fund or Emvest, Inc. (Opp'n at 7-8; Prelim. Inj. Order at 19.)

11 Defendants do not explain how obtaining duplicates of these documents would cause
12 unnecessary delay or otherwise hinder defense efforts. Upon Defendants' informal request,
13 the SEC has already produced over 10,000 pages of documents, transcripts, and other evidence
14 sought by defense counsel. (White Decl. ¶ 2.) There is no basis for assuming Defendants'
15 future requests would not be met with similar courtesy. Moreover, the Receiver has proposed
16 a compromise: he will make "Bates stamped" copies of any removed documents available to
17 both counsel and any other party (expert) who may be entitled to the document. (Receiver's
18 Response at 3.) Accordingly, the Court finds the Receiver acts within the scope of the
19 receivership in removing original documents from Defendants' premises, provided he makes
20 the copies promptly available.

21 **4. Five-Day Notice Requirement**

22 Defendants also request from the Receiver at least five days written notice prior to any
23 intended action beyond the ordinary, day-to-day business of the Fund. (App. at 1.) Absent
24 further information as to what types of impermissible actions the Receiver has taken, and how
25 five days notice would have been of aid to the Defendants, the Court finds Defendants' request
26

27 ² This Order specifically references the *Fund's* assets. It was the Fund, and not Emvest, Inc., which
28 the SEC claimed had been defrauding investors. Therefore, it remains possible that Emvest, Inc. could provide
a separate source for attorney's fees in this case, if Defendants can show how the Emvest, Inc. assets are
entirely unrelated to Fund investor proceeds.

1 to be an excessive burden on the Receiver. There is no guidance as to what types of acts would
2 fall outside the “ordinary, day-to-day business of the Fund,” sufficient to qualify for the
3 proposed five-day notice requirement.

4 In addition, although the Receiver must primarily serve the best interests of the
5 investors, he nonetheless functions as an officer of this Court (and not the SEC). Thus, the
6 Receiver has an affirmative duty to account for the concerns of all parties (including
7 Defendants) when operating the business. His role in this litigation is not necessarily in
8 conflict with the Defendants’ interests. Therefore, the Court is confident the Receiver will be
9 forthcoming in apprising Defendants and this Court (in advance) of any proposed actions that
10 fall squarely outside the Fund’s ordinary business operations—such as liquidating or selling
11 the business. With this in mind, no further modification of the receivership is necessary at this
12 time.

13 **5. Daily Business of the Fund**

14 Finally, Defendants seek clarification of the Receiver’s obligation to manage the Fund.
15 (App. at 4.) Defendants contend that on at least one occasion, the Receiver has refused to
16 consummate transactions which would have been profitable to the Fund. (*Id.*) Specifically,
17 the Receiver refused to sign trust deed assignments presented by Defendant Brock, stating
18 instead that he would be “freezing” all Fund activities for thirty days. (Brock Decl. ¶¶ 4, 5.)
19 The SEC responds that the Receiver has no duty to “blindly follow [Defendant] Brock’s
20 instructions, without questioning their propriety, [otherwise] the [R]eceiver would run the risk
21 of perpetuating [Defendant] Brock’s fraud.” (Opp’n at 8–9.) The SEC correctly points out
22 that the Court has given the Receiver control of the Defendants’ business operations; there is
23 no obligation to accede to every request made of him, without a determination whether such
24 action would be in the best interests of the investors. Whatever else the receivership in this
25 case entails, it is critical that the Receiver be given wide discretion to account for Fund assets
26 and bring the Funds’ books up to date. Accordingly, he may properly decide not to conduct
27 further loan transactions without first determining how such transactions would ultimately
28 benefit the investors. The Receiver has therefore acted within the scope of the receivership in

1 refusing to sign the trust deed assignments, and no further modification of the Order is
2 necessary.

3 **II.**

4 **CONCLUSION AND ORDER**

5 For these reasons, the Court's Preliminary Injunction Order and Appointment of
6 Permanent Receiver [Doc. 32] is hereby **CLARIFIED** as follows:

7 1. Defendants (and not the Receiver) remain in control of selection and retention
8 of defense counsel, and the ultimate decisions concerning defense strategy (including the
9 assistance of experts);

10 2. No further disbursements from the Fund's assets shall be expended on the
11 retention of defense counsel or experts;

12 3. The Receiver may remove original documents from the Defendants' premises,
13 provided the Receiver makes "Bates stamped" copies of such documents immediately available
14 to both counsel and any other party who may be entitled to the documents;

15 4. The Court declines to impose a five-day written notice requirement on the
16 Receiver's intended actions. However, the Receiver—as an officer of this Court—must act
17 reasonably in apprising this Court and all parties of any intended actions that will fall squarely
18 outside the Defendants' ordinary business operations.

19 5. The Receiver has an affirmative duty to conduct the business of the Fund.
20 However, the Receiver has a considerable amount of discretion in executing this duty.
21 Specifically, he may decline to sign trust deed assignments, without first showing that such
22 transactions were in the best interests of the investors.

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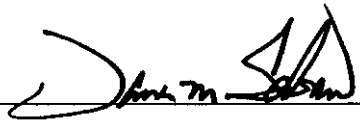
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1 6. The Court will entertain further requests for modification or clarification of the
2 Preliminary Injunction (or the Receiver's role) as they arise. Such requests shall be in the form
3 of a properly noticed motion, in accordance with the Federal Rules of Civil Procedure and the
4 Civil Local Rules of this Court.

5 **IT IS SO ORDERED.**

6 Dated: 12-20-04



DANA M. SABRAW
United States District Judge

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9 CC: ALL PARTIES
 JUDGE PAPAS

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