

**UNITED STATES DISTRICT COURT
FOR THE CENTRAL DISTRICT OF CALIFORNIA**

SECURITIES AND EXCHANGE COMMISSION,)
)
Plaintiff,)
)
v.)
)
TLC Investments & Trade Co.; TLC)
America, Inc. d.b.a. Brea Development)
Company; TLC Brokerage, Inc., d.b.a.)
TLC Marketing; TLC Development, Inc.;)
TLC Real Properties, RLLP-1; Ernest F.)
Cossey a.k.a. Frank Cossey; Gary W.)
Williams; Cloud & Associates Consulting,)
Inc.; and Thomas G. Cloud,)
)
Defendants,)
_____)

CASE NO. SA CV 00-960 DOC (EEEx)

ORDER GRANTING PLAINTIFF'S MOTION FOR PRELIMINARY INJUNCTION, ASSET FREEZE, APPOINTMENT OF RECEIVER, REPATRIATION OF ASSETS, PROHIBITION OF DESTRUCTION OF DOCUMENTS, EXPEDITED DISCOVERY, AND ACCOUNTINGS; DENYING DEFENDANTS WILLIAMS'S AND COSSEY'S EX PARTE APPLICATIONS FOR RELEASE OF FUNDS FOR LEGAL EXPENSES; VACATING AS WITHDRAWN DEFENDANT COSSEY'S EX PARTE APPLICATION FOR RELEASE OF FUNDS FOR LIVING EXPENSES; GRANTING IN PART DEFENDANT WILLIAMS'S EX PARTE APPLICATION FOR RELEASE OF FUNDS FOR LIVING EXPENSES

This is a securities fraud case brought by Plaintiff the Securities and Exchange Commission ("SEC"). On October 5, 2000, the Court entered a Temporary Restraining Order restraining the Defendants in this action from engaging in further securities fraud, appointing a temporary receiver, freezing Defendants' assets, repatriating foreign accounts, prohibiting the destruction of documents, granting expedited discovery, and ordering an accounting. The Temporary Restraining Order also constituted an Order to Show Cause why a preliminary injunction should not be entered, which was set for hearing on October 16, 2000. Defendants TLC America, Inc., E. Frank Cossey, and Gary Williams filed an Opposition, which contained an alternative request for more time to brief the issues. In an Order dated October 13, 2000 the Court granted this request and continued the hearing on the preliminary injunction to October 30, 2000, also extending the Temporary Restraining Order until 5:00 p.m. on October 30, 2000. TLC America, Inc. did not file anything further, but Cossey and Williams filed additional briefs.

After full consideration of the Complaint, all the briefs filed regarding the matter, and oral argument on October 30, 2000, the Court GRANTS the SEC's request for a preliminary injunction and for other ancillary forms of relief.

I.

BACKGROUND

In this action, the SEC brings suit against TLC Investments & Trade Co.; TLC America, Inc. d.b.a. Brea Development Co.; TLC Brokerage, Inc. d.b.a. TLC Marketing; TLC Development, Inc.; TLC Real Properties RLLP-1; Cloud & Associates Consulting, Inc.; Ernest F. Cossey a.k.a. Frank Cossey; Gary W. Williams; and Thomas G. Cloud. The TLC entities are allegedly operated by Cossey and Williams (all referred to collectively as "TLC Defendants"). Cossey is President of TLC America, Inc. and owns all of its stock. Williams is TLC America, Inc.'s Chief Financial Officer. TLC America, Inc.'s board of directors consists of Cossey, Williams, and Candyse B. Cossey, who is not a party to this action and is apparently Frank Cossey's wife. Cloud & Associates is allegedly operated by Cloud (all referred to collectively as "Cloud Defendants").

The SEC brings suit for: (1) violations of § 17(a) of the Securities Act, 15 U.S.C. § 77q(a) (fraud in the offer or sale of securities); (2) violations of § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5

thereunder, 17 C.F.R. § 240.10b-5 (fraud in connection with the purchase or sale of securities); and (3) violations of §§ 5(a) and 5(c) of the Securities Act of 1933, 15 U.S.C. §§ 77e(a) and (c) (offer and sale of unregistered securities) (against all Defendants except Williams). The SEC seeks an injunction, disgorgement, and civil penalties.

TLC Defendants purport to be in the business of buying distressed real estate, such as foreclosed properties, for resale at a profit. TLC Defendants issue two types of securities: promissory notes and one- or two-year, renewable investment agreements sold through TLC Brokerage's 130 agents nationwide. The SEC has submitted examples of promissory notes and investment agreements used by TLC Defendants. *See* Tercero Decl., Exs. 12, 13. The SEC has introduced as evidence TLC Defendants' advertising literature, brochures, promissory notes, investment agreements, and other documents related to their alleged business of buying real estate properties for resale. *See* Tercero Decl Exs. 14-21. From 1996 to the present, at least 2,627 investors, the majority of whom are senior citizens, have purchased TLC investments. TLC Defendants have raised over \$156 million from these investors. The SEC has filed numerous exhibits, including copies of checks, a property list, and Defendants' bank balances as evidence of this fact. In his initial inspection of TLC Defendants' premises and business records, the Temporary Receiver found that over \$159 million "of investor funds was logged into the customer database." Receiver's Initial Status Report at 4.

The SEC alleges that TLC Defendants have engaged in several kinds of securities fraud relating to their purported real estate business. First, the SEC alleges TLC Defendants misrepresented that they are doing real estate investments when in fact they are running a Ponzi scheme. According to the SEC, Defendants have used investor funds to: (1) pay other investors; (2) invest \$20 million in a fraudulent prime bank scheme; (3) buy racehorses; (4) make charitable contributions in the amount of \$1.55 million to a foundation that supports the football team at Cossey's son's high school, including \$1 million for repairs to the stadium; and (5) be wired overseas even though TLC securities' issuing documents said TLC never invested overseas. The SEC has filed various exhibits, attached to the Declaration of Roberto A. Tercero, as evidence for its allegations. Exhibits 23-35, which include contracts, wire transfer documents, and other documents, are put forth as evidence of the alleged investment in a fraudulent prime bank scheme. Exhibits 38-44, which include copies of cashier's checks, declarations, and wire transfer documents, are put forth as evidence of the alleged purchases of racehorses. Exhibits 45-48, including canceled checks, are proffered as evidence of charitable contributions. Copies of wire transfers have been filed as Exhibit 49 as evidence that TLC Defendants invested overseas. In conducting his initial inspection of TLC Defendants' premises and business records, the Temporary Receiver found records relating to 45 racehorses, a mare, and a filly. Records indicate that \$4.5 million or \$5.5 million was spent purchasing the horses, and the monthly cost of maintaining all the horses is \$94,000. The Temporary Receiver also was informed by Cossey's counsel that 250 racing dogs, located around the country and in Mexico, were purchased. The Temporary Receiver's Initial Status Report also states that after his review of TLC Defendants' books, he cannot account for \$24 million of funds raised from investors.

Second, the SEC alleges that TLC Defendants have misrepresented that they receive a 12-14% return on their investments when in fact they have been losing money, at least \$42 million, for the past two years. The SEC has filed Exhibits 50 and 51, consisting of client letters and account statements, as evidence of TLC Defendants' failure to provide a return. In his Initial Status Report, the Temporary Receiver states:

The companies [sic] accounting records show operating losses for 1998, 1999, and year to date 2000. The losses for 1998, 1999, and year to date 2000 were \$2.66 million, \$7.53 million, and \$2.97 million, respectively. It appears the cumulative losses approximating \$13.1 million are significantly understated for two reasons. Several million dollars of items that should have been expensed were capitalized and carried as assets. Based on a review of these items, the Receiver is unaware of any accounting principle that supports capitalizing these items. Secondly, the company recorded approximately \$20 million in sales of properties as revenue, but did not adjust asset value with a corresponding entry. This resulted in an overstatement of assets and an overstatement of income of about \$17 million.

Third, the SEC alleges that TLC America has misrepresented the safety of its investments by claiming that investors' funds are secured by deeds for real property in the investor's name as a tenant-in-common with TLC America when actually the deeds do not show any investors' names and in many cases are not recorded and do not have legal descriptions. Copies of deficient deeds have been filed as Exhibit 52 by the SEC. The Temporary Receiver's Initial Status Report also supports this claim, stating that the Temporary Receiver found no evidence at TLC Defendants' offices of deeds being recorded and no evidence of investors' names being used on deeds.

Fourth, the SEC alleges that TLC America has misrepresented that Cossey has business expertise when actually he was the subject of a 1996 chapter 7 bankruptcy.

The SEC alleges that Cloud Defendants are engaging in affinity fraud by promoting, offering, and selling TLC

securities through Cloud Defendants' website, <www.cloudassoc.com>, and by promoting them through an Internet radio broadcast hosted by Cloud on a Christian-themed website, <www.oneplace.com>. The SEC has introduced selected pages from Cloud Defendants' website as evidence. *See* Tercero Decl., Ex. 22. The SEC alleges that Cloud Defendants, as well as TLC Defendants, have made material misrepresentations. The SEC alleges misrepresentations relating to the following: (1) the return on investment; (2) the types of properties that the TLC entities purchase; (3) that Cloud Defendants have independently investigated TLC investments and found them to be profitable; and (4) that Cloud & Associates receives no commissions on sales of TLC investments when in fact it has received over \$1 million in commissions.

No Defendant has provided any specific rebuttals to the SEC's allegations. Cossey and Williams have each asserted that answering questions or providing information about the specific allegations would violate their rights under the Fifth Amendment to the U.S. Constitution. *See* Cossey Depo. (refusing to answer any questions related to the case on grounds of the Fifth Amendment); Williams's Statement Re: Fifth Amd. Privilege.

TLC America, Inc., joined by Cossey and Williams, opposes entry of the preliminary injunction on the grounds that TLC Defendants do hold some real property with significant value. Cossey's counsel states that a TLC employee, Steven Katz, told him on September 26, 2000, that TLC properties have a fair market value, based on comparable sales rather than appraisals, of \$145 million. *See* Steward Decl. Re: Property Valuation ¶2. However, the SEC submits a declaration from Katz, drafted after this litigation began, in which Katz states that the value of the property is "considerably less" than \$122 million. *See* Katz Decl. ¶7. Attached to this declaration is a TLC spreadsheet showing the value of its properties. Katz states that the values shown on this spreadsheet are "overstated" because they include anticipated improvements that have not been made. *See* Katz Decl. ¶7. The Temporary Receiver also found, while doing his initial investigation of TLC Defendants' offices, an internal database that showed the value of the properties, without improvements, as approximately \$41 million.

As alternative evidence, Defendants submit a different spreadsheet showing properties owned by TLC entities. *See* Steward Decl. Re: Property Valuation, Ex. A. This spreadsheet shows the fair market value of each property, and according to Defendants the total value of the properties listed on the sheet is approximately \$175 million. Cossey's counsel states that he does not know who completed this spreadsheet. *See* Steward Decl. Re: Property Valuation ¶3. Cossey's counsel also states that he spoke with TLC Defendants' insurer, who reported that TLC properties are insured at a value of \$90 million, which is usually lower than replacement cost. *See* Steward Decl. Re: Property Valuation ¶4. Defendants state that they cannot provide further evidence in support of their position because federal law enforcement agents seized many of the records and the Temporary Receiver now has control over TLC Defendants' offices. However, they concede that the Temporary Receiver told them that they could depose anyone on two days notice. *See* Suppl. Mem. on Behalf of Def. Williams Replying to Pl.'s Opp'n to *Ex Parte* Application at 7:17-19. Apparently they have not yet taken any such depositions.

At oral argument, the SEC stated that a rough, non-binding estimate of the potential liability in this case is \$70 million.

II.

PRELIMINARY INJUNCTION

The SEC seeks a preliminary injunction to prevent Defendants from engaging in further acts of securities fraud.

A. Legal Standard

Injunctive relief is expressly authorized by Congress to proscribe future violations of federal securities laws. *See* 15 U.S.C. § 78u(d)(1). {{|1| This statute provides, "Whenever it shall appear to the Commission that any person is engaged or is about to engage in acts or practices constituting a violation of any provision of this chapter, the rules or regulations thereunder, . . . , it may in its discretion bring an action in the proper district court ... to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond."}} Generally, courts grant equitable relief in the event of irreparable injury and the inadequacy of legal remedies. *See Stanley v. University of S. Cal.*, 13 F.3d 1313, 1320 (9th Cir. 1994). Plaintiffs must satisfy additional requirements in order to be granted preliminary relief. The "traditional test" requires that the plaintiff demonstrate: (1) a strong likelihood of success on the merits; (2) the possibility of irreparable injury; (3) greater hardship to the plaintiff than to the defendant; and (4) that the public interest favors granting the injunction. *See Johnson v. California State Bd. of Accountancy*, 72 F.3d 1427, 1430 (9th Cir. 1995); *Atari Games Corp. v. Nintendo of Am., Inc.*, 897 F.2d 1572, 1575

(Fed. Cir. 1990) (discussing Ninth Circuit law); *State of Alaska v. Native Village of Venetie*, 856 F.2d 1384, 1388 (9th Cir. 1988); *Los Angeles Memorial Coliseum Comm'n v. National Football League*, 634 F.2d 1197, 1200 (9th Cir. 1980). In some situations, an "alternative test" can be applied: "When the balance of hardships tips decidedly toward the plaintiff," a preliminary injunction may be issued upon a less rigorous showing of likelihood of success on the merits so long as the plaintiffs allegations raise "serious questions" as to the merits. *Caribbean Marine Servs. Co. v. Baldrige*, 844 F.2d 668, 674 (9th Cir. 1988); *American Motorcyclist Ass'n v. Watt*, 714 F.2d 962, 965 (9th Cir. 1983); *Stanley*, 13 F.3d at 1319.

When the party seeking a preliminary injunction is a governmental agency seeking to enforce a statute and that party satisfactorily shows the likelihood of success on the merits, the presence of the second and fourth factors, the possibility of irreparable injury and that the injunction serves the public interest, is presumed. *See United States v. Nutri-Cology, Inc.*, 982 F.2d 394, 397-98 (9th Cir. 1992). This is because "the passage of the statute is itself an implied finding by Congress that violations will harm the public." *Id.* at 398. Courts from other circuits have noted that this rule applies to the SEC. *See SEC v. Unifund SAL*, 910 F.2d 1028, 1037 (2d Cir. 1990) ("[T]he SEC, in discharging its statutory responsibilities, is relieved of the burden of showing a risk of irreparable injury so that it may secure a preliminary injunction more easily than a private litigant.").

On several occasions, the Second Circuit has addressed the entry of preliminary injunctions in suits brought by the SEC to enforce federal securities laws. The Second Circuit holds that the SEC demonstrates a sufficient likelihood of success on the merits when it makes a substantial showing of likelihood of success as to both a current violation and the risk of repetition. *See SEC v. Cavanagh*, 155 F.3d 129, 132 (2d Cir. 1998). To determine if this standard has been met, a district court exercising equitable discretion should consider: (1) whether the defendant has been found liable for illegal conduct; (2) the degree of scienter involved; (3) whether the infraction is an isolated occurrence; (4) whether the defendant continues to maintain that his past conduct was blameless; and (5) whether, because of his professional occupation, the defendant might be in a position where future violations could be anticipated. *See id.* at 135.

The Second Circuit has also stated that the SEC "should be obliged to make a more persuasive showing of its entitlement to a preliminary injunction the more onerous are the burdens of the injunction it seeks." *Unifund SAL*, 910 F.2d at 1038. Thus, although the Second Circuit's formulation of the general preliminary injunction test is stated differently from the Ninth Circuit's as it does not include the phrase "tipping of the balance of the hardships," the same underlying concerns are addressed by this test.

There is no Ninth Circuit authority directly considering the entry of preliminary injunctions in federal securities cases brought by the SEC. The Court finds the reasoning of the Second Circuit to be persuasive. In addition, the Second Circuit's reasoning is consistent with the general test for the entry of a preliminary injunction used by the Ninth Circuit. Therefore, the Court adopts the tests used by the Second Circuit. A preliminary injunction should be issued if the SEC has made a substantial showing of likelihood of success as to both a current violation and the risk of repetition and if this showing is sufficient to justify the entry of the injunction sought, considering the hardships that will be imposed by that injunction.

B. Application

1. Likelihood of Success on the Merits

The SEC has made a substantial showing of likelihood of success as to both a current violation and the risk of repetition. Although the first and third factors suggested by the *Cavanagh* court, whether the defendant has already been found to have committed illegal acts and whether the defendant continues to assert that such acts were blameless, do not support the SEC here because there is no indication in the record that any of Defendants has been held liable for such conduct in the past, the other three factors strongly support a finding of likelihood of success on the merits.

The allegations in the Complaint, backed up by the numerous exhibits submitted by the SEC and the findings of the Temporary Receiver in his Initial Status Report, demonstrate a continuing course of illegal conduct. The evidence suggests much more than an "isolated occurrence"; instead, the evidence supports the SEC's claim that Defendants engaged in numerous illegal acts on many different occasions. The Court may draw a limited inference of scienter from Williams's and Cossey's invocations of the Fifth Amendment. *See SEC v. International Loan Network, Inc.*, 770 F. Supp. 678, 695-96 (D.D.C. 1991) ("The Court is further convinced that an ultimate finding of scienter is likely because of the failure of defendants . . . to testify in rebuttal to the claims against them."). Although failure to rebut allegations alone is not probative, when considered on the facts of the case and in conjunction with other evidence it can suggest scienter. *See id.* Here, the flagrant nature of the alleged misrepresentations and fraudulent acts also strongly suggests scienter of the illegal nature of such acts. Finally, Defendants' professional positions at TLC make it likely that they

would continue to engage in actions similar to the ones alleged.

Defendants have proffered nothing to counter the SEC's specific claims. Williams and Cossey as individuals have the right under the Fifth Amendment not to incriminate themselves, but none of the other corporate Defendants have made any showing either. In addition, although Williams and Cossey have the right not to speak or answer questions, their assertion of that right does not require the Court to ignore the showing made by the SEC and the evidence it has already submitted, which strongly suggests that the SEC has a likelihood of success on the merits.

Defendants' attempts to assert that TLC entities do hold real estate with significant value also do not counteract the showing made by the SEC. Katz's assertions prior to the entry of the Temporary Restraining Order are not only hearsay but are directly contradicted by the sworn declaration he has submitted in connection with this litigation. According to this declaration, TLC properties have a fair market value of much less than \$122 million. In addition, in his review of TLC Defendants' books and records the Temporary Receiver found an internal valuation report showing a total value of under \$42 million, not including improvements. *See Receiver's Initial Status Report* at 3. Although Defendants have submitted another spreadsheet showing fair market values of higher amounts, they provide no evidence to substantiate the values claimed on that spreadsheet. Although they claim various values for the property, ranging from \$122 million to \$175 million, considering that TLC Defendants raised approximately \$156 million in principal alone from investors such a showing is not enough to refute the SEC's claim that they did not deliver on the promised return of 12-14% to investors. TLC Defendants' argument also does not refute the SEC's claim that TLC Defendants promised investors they would invest their money in real estate but instead used a substantial portion of it for other purposes.

2. Hardship to Defendants

The requested injunction enjoins Defendants from engaging in acts of securities fraud. Here, the seriousness of the SEC's allegations, the substantial evidence it has in support of its claims, and the great risk of harm to investors if no injunction is entered outweigh any burden on Defendants. Therefore, the Court GRANTS the SEC's request for a preliminary injunction.

III.

ASSET FREEZE

When the SEC brings suit for a violation of federal securities laws, an asset freeze can be appropriate even if the SEC has not made the necessary showing for the entry of a preliminary injunction. Assets can be frozen when the SEC establishes that it is likely to succeed on the merits. *See Cavanagh*, 155 F.3d at 132. The SEC need not make any showing that a future violation is likely. The purpose of an interlocutory freeze order is to prevent dissipation of assets and ensure that funds will be available to satisfy any relief ordered after trial, including disgorgement and civil penalties. An interlocutory freeze should be remedial only, not punitive, as no violation has yet been proven, and therefore freezing assets above and beyond what may be a part of the judgment is inappropriate. *See Unifund SAL*, 910 F.2d at 1041-42. Some courts also hold that the SEC should show that the frozen assets are fairly traceable to the alleged wrongdoing. *See, e.g., SEC v. International Loan Network, Inc.*, 770 F. Supp. 678, 697 (D.D.C. 1991), *aff'd*, 968 F.2d 1304 (D.C. Cir. 1992). However, the Second Circuit does not impose such a requirement. *See Cavanagh*, 155 F.3d at 132 ("An asset freeze requires a lesser showing [than a preliminary injunction]; the SEC must establish only that it is likely to succeed on the merits."); *Unifund SAL*, 910 F.2d at 1401; *SEC v. Heden*, 51 F. Supp. 2d 296, 297 (S.D.N.Y. 1999).

Under these rules, a freeze of the corporate Defendants' assets is easily justified. At oral argument, the parties debated whether a freeze of the individual Defendants' assets also is proper. Williams's counsel noted that the SEC has done little to show that Williams's personal assets can be traced to the alleged wrongdoing. The purpose of a freeze is to ensure that whatever funds are currently available to satisfy a judgment will be available when a judgment, if the SEC proves its case at trial, is finally entered. *See Unifund SAL*, 910 F.2d at 1041 ("[T]he freeze order simply assures that any funds that may become due can be collected."). The individual Defendants in this case could be jointly and severally liable and could be required to satisfy any judgments that may be obtained against them out of their own personal assets. As the individual Defendants in this case could be personally liable for a judgment, an interim freeze of their personal assets is necessary to ensure that a future judgment could be satisfied. The potential liability in this case is \$70 million; Defendants have made no showing that the frozen assets exceed this amount. Therefore, the Court will follow the rule of the Second Circuit. The Court holds that a freeze of all assets of all Defendants, including the personal assets of the individual Defendants, is appropriate.

Cossey and Williams have both applied *ex parte* for funds to be released from the asset freeze for their use (1) to retain counsel to defend themselves in this matter and (2) to pay for living expenses. In addition, the SEC has raised the issue of whether certain funds transferred prior to the entry of the Temporary Restraining Order to counsel retained to represent Cossey and Williams in any criminal proceedings are subject to the freeze. This latter issue will be considered first.

A. Funds Subject to the Freeze

On September 14, 2000, federal law enforcement agents conducted searches of TLC Defendants' offices and of Cossey's home. Four days later, on September 18, 2000, H. Dean Steward, of the law firm of Steward & Miller, agreed to represent Cossey in any criminal proceedings and assist during the SEC's investigation. Cossey authorized the transfer of \$530,000 to Steward & Miller. It is undisputed that this money came from TLC corporate funds. *See* Steward Decl. of Oct. 12, 2000 ¶3 (describing "funds from TLC America, Inc."); Riddet Decl. of Oct. 13, 2000, Ex. A (Williams's retainer agreement, on which is handwritten, "Fees set forth above are being paid by TLC America Inc. and related entities"); Williams Decl. Re: Transfer of Funds to Steward & Miller ¶2 (discussing the "transfer of funds from TLC America, Inc. to Steward & Miller, on September 20, 2000"). Steward & Miller deposited this money on September 20, 2000. *See* Steward Decl. of Oct. 12, 2000, Ex. B.

Steward states, "In connection with my duties for my client, I was asked to coordinate the retaining of qualified counsel for various employees and agents of TLC America. I received an initial \$30,000 check, followed almost immediately by a \$500,000 wire transfer, both being deposited in my firm's trust account. I then selected counsel and negotiated fees." Steward Decl. of Oct. 12, 2000 ¶3. An exhibit submitted by Steward indicates that he distributed the \$530,000 on September 20, 2000 as follows:

- \$125,000 was kept by Steward for representation of Defendant Cossey;
- \$125,000 was given to attorney James Riddet for representation of Defendant Williams;
- \$35,000 was given to attorney James L. Sanders for representation of TLC America, Inc.;
- \$40,000 was given to other attorneys to represent individuals affiliated with TLC but who are not parties to this action (James L. Waltz received \$10,000 to represent "TLC Employees"; John Martin received \$15,000 to represent "A. Barkate, R. Chan"; and Paul Meyer received \$15,000 to represent "Mrs. Cossey"); and
- \$7,500 was given to a private investigator.

See Steward Decl. of Oct. 12, 2000, Ex. B. According to Williams's retainer agreement, signed on September 20, 2000, the additional sum of \$98,750 was placed in a client trust account for Williams. According to Cossey's retainer agreement, signed on September 28 and 30, 2000 but stating that the fees indicated therein were earned as of September 18, 2000, the additional sum of \$98,750 was placed in a client trust account for Cossey. The sum of these two client trust accounts and the expenditures noted with bullet points above is \$530,000.

Steward states that on October 2, 2000, Sanders returned the \$35,000 given to him. Using this returned money, Steward added \$20,000 to Cossey's client trust account, bringing it to a total of \$118,750. Regarding the remaining \$15,000, Cossey's briefs were contradictory and unclear, but at oral argument Cossey's counsel, Steward, explained that he gave the \$15,000 to Anthony Barkate, who is apparently the "A. Barkate" who was already being represented by John Martin. Steward stated that he gave Barkate this money on October 3, 2000, and it was his understanding that Barkate paid it to Sheldon Jaffe but he had no information as to whether this had occurred and, if so, on what date. During a recess near the close of oral argument, the Court received a note from the SEC indicating that Jaffe has returned the \$15,000 to the Temporary Receiver. This note also indicates that Martin returned the \$15,000 he received for the representation of Barkate and Chan to the Temporary Receiver.

The SEC contends that all of the \$530,000 should be frozen. The \$530,000 was distributed by Steward & Miller in four different ways: (1) the \$250,000 paid as "retainers," \$125,000 to Steward for the representation of Cossey and \$125,000 to Riddet for the representation of Williams; (2) the \$217,500 split into two client trust accounts, \$118,750 held by Steward & Miller for Cossey and \$98,750 held by James & Riddet for Williams; (3) the \$25,000 paid to other attorneys for the representation of other individuals, who are not parties to this action that has not been returned; and (4) the \$7,500 paid to an investigator. Each of these categories presents a slightly different situation. The Court will first discuss the status of each of these categories under the traditional rules applicable to retainer agreements and then discuss other arguments raised by the SEC and the Temporary Receiver.

1. Traditional Rules Regarding Retainer Agreements

"A classic retainer 'is a sum of money paid by a client to secure an attorney's availability over a given period of time. Thus, such a fee is earned by the attorney when paid since the attorney is entitled to the money regardless of whether he actually performs any services for the client.' By contrast, a retainer given as an advance deposit against future fees constitutes property held in trust for the benefit of the client and, as such, is property of the client." *SEC v. Interlink Data Network of Los Angeles, Inc.*, 77 F.3d 1201, 1205 (9th Cir. 1996) (citation omitted) (quoting *Baranowski v. State Bar of Cal.*, 24 Cal. 3d 153, 163 n.4, 154 Cal. Rptr. 752, 757 n.4 (1979)).

Under this definition, the retainers of \$125,000 each for the representation of Cossey and Williams are classic retainers. Defendants have submitted copies of these fee agreements, and these agreements provide that the amounts are paid in full, are not refundable, and are earned upon receipt. *See* Riddet Decl. of Oct. 13, 2000, Ex. A §§ 3, 8 (retainer agreement for Williams); Steward Decl. of Oct. 12, 2000, Ex. A § A (retainer agreement for Cossey). In *Interlink*, the court held that the agreement at issue was not a retainer because it was an "advance deposit"; the agreement itself provided that the deposit was not earned until expenses were incurred; when presented with an invoice the defendant could either pay the invoice, thus replenishing the "deposit," or allow the invoice to be paid out of the deposit; and the agreement provided that whatever portion of the deposit was left over after termination of the relationship would be refunded. *See Interlink*, 77 F.3d at 1205. The retainer agreements entered into by Cossey, Williams, and their respective counsel have none of these characteristics and instead have all the characteristics of classic retainers. Thus, under the traditional rules applicable to retainers, Riddet's \$125,000 retainer for representation of Williams and Steward's \$125,000 retainer for representation of Cossey would not be subject to the freeze.

The \$217,500 held in client trust accounts for Cossey and Williams, however, is not a classic retainer. The Williams agreement provides, "Additional fees are possibly necessary--especially if a trial becomes necessary. An amount of \$98,750 is hereby placed in trust for cost[s], experts, investigation and att[orne]y[s] fees to be incurred in future." Riddet Decl. of Oct. 13, 2000, Ex. A § 9. The agreement thus specifically states that the funds are held "in trust," and it is only "possibl[e]" that they will need to be spent. The Cossey agreement provides, "Client has also deposited \$98,750 in Steward & Miller's client trust account. This sum is held in reserve, specifically for legal representation." {{ |2| This agreement was signed before Sanders returned the \$35,000 he had been given to represent TLC America, Inc. As explained, after this money was returned, Steward added \$20,000 to Cossey's trust account, bringing it to a total of \$118,750.}} Steward Decl. of Oct. 12, 2000, Ex. A § A. Money held in trust or in reserve has not yet been earned by the firm and is still subject to the payor's control. *See Interlink*, 77 F.3d at 1205. Therefore, the money held in trust accounts, \$98,750 for Williams and \$118,750 for Cossey, is subject to the asset freeze and should be paid over to the Receiver.

Because the \$15,000 received by Jaffe and the \$15,000 received by Martin were returned to the Receiver, the only other portions of the \$530,000 that have not been accounted for are the \$ 10,000 paid to Waltz and the \$15,000 paid to Meyer for the representation of individuals who are not parties to this action and the \$7,500 paid to a private investigator by Steward. None of the agreements regarding these fees have yet been submitted to the Court. Thus, it is impossible to determine whether they are classic retainers or instead trust accounts or advance fee deposits. Without knowing this information, the Court cannot determine whether, under the traditional rules for retainers, these funds are subject to the freeze.

2. Public Policy

The SEC argues that whatever the traditional rules regarding retainer agreements, Defendants may not use funds illegally and wrongfully obtained from investors to pay for their own defense.

The SEC has cited one case that held that a retainer agreement purposefully crafted to avoid impending asset freezes was void as against public policy, even though the retainer otherwise satisfied the requirements for being a fully earned, non-refundable retainer. In *SEC v. Comcoa Ltd.*, 887 F. Supp. 1523-24, (S.D. Fla.), *aff'd*, 70 F.3d 1191 (11th Cir. 1995), an individual under investigation by the SEC entered into a fee agreement with an attorney which provided that a trust account would automatically convert to a non-refundable retainer at the moment the SEC instituted an action against the individual. The court held that although retainers usually become the property of the law firm, this retainer agreement was unenforceable because it was void as against public policy. The court stated:

[G]iven [the attorney's] vast experience with the securities laws, the Court finds that, without a doubt, [the attorney] drafted the retainer agreement with the intention of circumventing federal securities laws.... [the attorney] has protected (his) own economic interests at the expense of others. Indeed, to uphold this type of

retainer agreement would not only render the SEC powerless to effectively freeze assets to protect the interests of defrauded investors, but would also, in essence, require the defrauded investors to foot the bill of their opposing counsel. Such an outcome is extremely offensive to this Court, and unquestionably contrary to public policy and the intent and goals of the federal securities laws.

Comcoa, 887 F. Supp. at 1525.

Here, the retainer agreements entered into by Cossey and Williams have no loopholes or automatic conversion provisions. The SEC argues that the fact that the agreements exist at all is evidence that attorneys Steward and Riddet purposefully tried to assist in circumventing an asset freeze. In *Interlink*, the Ninth Circuit considered whether a refundable advance deposit paid to an attorney prior to the entry of a temporary restraining order was subject to a freeze. Notably, it allowed the attorney to keep the portion of the fees that had been fully earned prior to the entry of the temporary restraining order. *See Interlink*, 77 F.3d at 1206. In that case, the attorney had received \$70,000 by the date the temporary restraining order was entered. *See id.* at 1202-03. It was undisputed that he had already earned \$28,177 of that amount. *See id.* The district court ruled that the attorney could keep the remaining \$41,823, and it was this ruling that was reversed by the Ninth Circuit. The Ninth Circuit did not disturb the district court's decision that the portion earned prior to the freeze could be kept by the attorney. Remanding the case, the court specifically stated that it was remanding for further proceedings regarding "the portion of the advance deposit not yet earned" by the attorney. *Id.* at 1207. The Court even went so far as to state, "Because we reverse on this ground, we do not address the SEC's argument that the funds were fraudulently obtained by Interlink and therefore title to the funds never passed to [the attorney]." *Id.* at 1206 n.7. Thus, the Ninth Circuit was aware of this argument, but did not apply it to require the return of sums paid prior to the entry of a temporary restraining order, so long as those sums were fully earned by the attorney and were not a deposit or otherwise refundable. {{3| The Court similarly concludes that it cannot require Steward and Riddet to return the money on the grounds that it may have been paid to them in violation of California corporate law. The Temporary Receiver and the SEC point out that only in limited circumstances and under specified procedures can corporate assets be used to pay for the defense of corporate officers. Defendants contend that they complied with these requirements. The Receiver may be able to bring a claim regarding such a violation, but the issue is not properly before the Court at this time.}}

The Temporary Receiver also argues that a constructive trust should be found. "In a constructive trust, a person who has engaged in fraud or other wrongful conduct holds only bare legal title to the property subject to a duty to reconvey it to the rightful owner." *FTC v. Crittenden*, 823 F. Supp. 699, 703 (C.D. Cal. 1993), *aff'd without opinion*, 19 F.3d 26 (9th Cir. 1994). The Temporary Receiver is correct to note that a constructive trust arises at the point when the acts giving rise to the constructive trust occur, rather than when a court later decrees them to be wrongful. *See Simpson v. Gillis*, 1 Cal. 2d 42, 54, 32 P.2d 1071, 1077 (1934). However, that rule comes into play when, as in *Crittenden*, a court is faced with a *post hoc* situation of determining which claimant has the right to certain property. If the SEC's allegations are correct, Defendants obtained funds from investors wrongfully, and therefore have held those funds in constructive trust from the moment they obtained them. However, the SEC's allegations are not yet proven. Thus, the Temporary Receiver's argument raises two questions: (1) does a constructive trust exist at this time; and (2) can the Court, at this point in time, determine the answer to that first question. It is quite possible that the answer to the first question is yes. However, the answer to the second question is no. If the Court were to determine now that a constructive trust exists and on that basis order Steward and Riddet to return the retainers, it would be determining that, in fact, Defendants wrongfully held investors' funds. While the Court, in granting the motion for a preliminary injunction, has held this is likely to be so, it cannot conclude at this point in time that the SEC has in fact proven its case.

Therefore, the \$125,000 retainers paid to Steward and Riddet for the representation of Cossey and Williams, respectively, are not subject to the asset freeze. However, the \$217,500 held in trust by Steward & Miller and Stokke & Riddet is subject to the asset freeze imposed by this Court and those firms are ordered to pay that money over to the Receiver. Regarding the \$ 10,000 paid to Waltz, the \$15,000 paid to Meyer, and the \$7,500 spent by Steward & Miller on a private investigator, Steward, Cossey's counsel, is ordered to provide to the Court whatever information he has about these agreements by November 7, 2000. Copies of the actual fee agreements would be of great assistance to the Court, but the Court is unsure of whether the agreements are within the control of any parties to this action. Accordingly, any party who desires to do so may submit a brief regarding this issue by November 7, 2000.

B. Release of Additional Funds for Legal Expenses

Having determined that Steward and Riddet may keep the retainers they received prior to the entry of the

Temporary Restraining Order, the Court must also address Cossey's and Williams's original contention, that additional funds should be released from the freeze to enable them to obtain counsel other than Steward and Riddet for this matter in particular. According to Steward and Riddet, they are criminal attorneys with no experience in civil matters and are not qualified to provide defense in this action. The retainer agreements discussed above explicitly indicate that the scope of the representation is limited to criminal defense and only limited investigation or assistance in a civil matter such as this one.

Whether to release funds from an asset freeze for the payment of legal expenses is a matter within the district court's discretion. *See CFTC v. Noble Metals Int'l, Inc.*, 67 F.3d 766, 775 (9th Cir. 1995). Even in a criminal matter, a court is not required to release wrongfully obtained funds from a freeze for the defendant to use to pay for the costs of defense. *See Caplin & Drysdale, Chartered v. United States*, 491 U.S. 617, 626, 109 S. Ct. 2646, 2652, 105 L. Ed. 2d 528 (1989) ("A defendant has no Sixth Amendment right to spend another person's money for services rendered by an attorney, even if those funds are the only way that that defendant will be able to retain the attorney of his choice. A robbery suspect, for example, has no Sixth Amendment right to use funds he has stolen from a bank to retain an attorney to defend him if he is apprehended."); *SEC v. Grossman*, 887 F. Supp. 649, 661 (S.D.N.Y. 1995) ("[I]t is well-established that there is no right to use the money of others for legal services."). The Ninth Circuit has held that it is not an abuse of discretion for a district court to refuse to release funds for legal expenses when the frozen assets fall far short of the amount needed to satisfy a judgment. *See Noble Metals*, 67 F.3d at 775. However, the Ninth Circuit has also stated, "We do not . . . intimate that attorney fee applications may always be denied where the assets are insufficient to cover the claims. Discretion must be exercised by the district court in light of the fact that wrongdoing is not yet proved when the application for attorney fees is made." *Id.* In exercising this discretion, courts consider factors such as whether the frozen assets include personal assets that have been shown to be obtained legally and whether without a release of funds, the defendant will have no ability to retain counsel at all.

The Court will not release anything from the \$217,500 paid from TLC America, Inc. corporate funds to Steward and Riddet to be held in trust for Cossey and Williams. All TLC America, Inc. funds were raised from investors, and the SEC has made a significant showing that these funds have been squandered and misused and were fraudulently raised. The Court also will not release any of Williams's or Cossey's personal assets for legal expenses at this time. The SEC has made a showing that their personal assets include funds wrongfully diverted from TLC and Williams and Cossey have not countered that showing. In addition, Williams and Cossey have not demonstrated that a release of funds is the only way they will be able to retain counsel. They have asked to be able to hire counsel who require \$50,000 retainers, but these attorneys charge at the higher end of the range of fees charged by attorneys in this community. Furthermore, Williams and Cossey are not completely without legal assistance, as Steward and Riddet may be available to them. Steward and Riddet may be more experienced in criminal matters, but they appear to be competent, resourceful attorneys. In addition, in similar situations, other courts have noted that defendants also have the option of finding attorneys to take their case on a contingency arrangement or some other type of future payment plan. They could also pay attorneys out of income earned from new jobs taken up now, unrelated to TLC.

Finally, Cossey and Williams have not demonstrated that the frozen assets are more than enough to satisfy a potential judgment. According to the Complaint and the Temporary Receiver's Initial Status Report, principal of approximately \$25 to \$50 million dollars is owed to investors. This is aside from the fact that investors were promised a 12-14% profit. At oral argument, the SEC made a rough, nonbinding estimate that a judgment in this case could be as high as \$70 million. No complete accounting has yet been submitted to the Court, but Cossey and Williams have not demonstrated that the frozen assets come close to paying back this amount, let alone exceeding it. In fact, they do not make this argument. Instead, they argue:

[P]laintiff attached an exhibit listing \$122 million in assets. If plaintiff is correct that the total invested is slightly over \$150 million, that would mean that if everything was liquidated today for \$122 million, the victims would get 81 cents on the dollar. That is hardly far short [alluding to the Noble Metals case]. In addition, . . . there is an additional asset in the form of a residence which was deeded over by the person or entity which received the \$20 million investment [referring to the alleged prime bank scheme].... Thus, at the very least, the total assets is [sic] closer to \$130 million.

In addition to the above, it is unrealistic to assume that all investors would immediately want their money back.

Reply of Gary W. Williams to Pl.'s Opp'n to Application to Modify Temp. Restraining Order at 7:8-18. The Court strongly disagrees with Defendants' contention that 81 cents on the dollar is good enough for defrauded investors, and the Court further finds it realistic to assume that most investors will want their money back fairly quickly, if the SEC succeeds in proving its case at trial.

Therefore, at this time no funds will be released from the freeze for Cossey and Williams to use to pay legal expenses. This denial is without prejudice to further requests from Cossey and Williams, after they make full accountings. {{|4| Cossey has indicated that he will not be providing an accounting at this time because of his rights under the Fifth Amendment and because federal law enforcement agents have seized many of his financial records. This is his right to do but it leaves the Court unable to determine whether the release of funds would be proper.}}

C. Release of Funds for Living Expenses

Whether to release funds for living expenses is also within the district court's discretion. At oral argument, counsel for Cossey withdrew Cossey's request for a release of funds at this time, indicating that he was in the process of obtaining additional information about a particular bank account of Cossey and that he would present that information to the Court at a later time.

Williams has submitted a declaration and a financial statement containing some information. According to the declaration, his wife earns an income of \$1,875 every other week, Williams received gross pay of \$1,500 a week from TLC, and their monthly living expenses are \$6,510. At oral argument, the Temporary Receiver confirmed that Williams had been receiving a salary of \$1,500 a week. Under the Temporary Receiver's supervision, TLC paid Williams his customary salary after the Temporary Receiver initially took possession of the TLC entities. Williams's counsel stated that the Temporary Receiver informed Williams a few days ago that he would no longer pay him a salary. The Court asked the Temporary Receiver at oral argument if Williams could provide any services of value to TLC that would justify further salary payments, and the Temporary Receiver said no.

The Court notes that several of the items on Williams's expense statements are non-essential items that can be done without, such as \$29 a month for cable television, \$225 a month for clothing, \$149 a month in telephone bills, and \$200 a month in home and yard maintenance. The Court also notes that Williams's wife's income is still available. However, the Court accepts the Receiver's representation that there is no justifiable business reason to pay Williams to work at TLC at this time. Williams's counsel stated at oral argument that Williams, a trained CPA, is planning to look for other work. The Court strongly encourages Williams to pursue other options as quickly as possible. The Court will release from the freeze the money in the bank accounts identified at oral argument as being money earned by Williams's wife. This amount of money, approximately \$8,000, should be enough when combined with the wife's current income to enable the Williamses to pay necessary and reasonable living expenses until Williams obtains other employment. Williams is ordered to supply to the Court, the SEC, and the Receiver by 5:00 p.m. on October 31, 2000 the locations, account numbers, and bank records showing the balances of the wife's accounts.

IV.

OTHER ANCILLARY RELIEF

The SEC also requests that the Court appoint a permanent receiver, order repatriation of funds Defendants have placed abroad, prohibit the destruction of documents, allow expedited discovery, and order a full accounting. All of these forms of relief are appropriate. Courts have inherent equitable power to grant "ancillary relief" in securities cases. *See SEC v. Wencke*, 622 F.2d 1363, 1369 (9th Cir. 1980). A receiver is particularly appropriate here (1) to protect the investors and the public and (2) because a substantial portion of the money is invested in assets such as real estate, racehorses, and racing dogs, all of which need to be managed. Therefore, the Court GRANTS the SEC's request for these forms of relief. Robb Evans is appointed as the Receiver.

V.

CONCLUSION

For the foregoing reasons, the Court GRANTS Plaintiff's request for a preliminary injunction, the appointment of a receiver, repatriation of funds placed abroad, a prohibition on the destruction of documents, expedited discovery, and a full accounting. Robb Evans is appointed as the Receiver.

In addition, the assets of all Defendants will remain frozen. The \$125,000 retainer paid to Steward for the representation of Cossey and the \$125,000 retainer paid to Riddet for the representation of Williams are not subject to the freeze, but the \$217,500 held in client trust accounts is frozen and is ORDERED to be paid over to the Receiver. The Court requires further briefing regarding the remaining \$32,500 paid to Steward & Miller on September 20, 2000.

Briefs on this subject are to be submitted by November 7, 2000, and no replies will be accepted. No additional funds will be released for legal fees at this time, but Defendants may renew their requests if they submit full accountings. No funds will be released for living expenses for Cossey at this time. The funds in bank accounts earned by Williams's wife will be released from the freeze for living expenses for the Williamses. Williams is to provide the Court, the SEC, and the Receiver with evidence regarding these accounts by 5:00 p.m. on October 31, 2000. Defendants may renew their request for the release of funds for reasonable living expenses if and when their situations change.

Plaintiff is to prepare, lodge, and serve via facsimile a proposed order entering the preliminary injunction consistent with this opinion by 5:00 p.m. on October 31, 2000. The Temporary Restraining Order will remain in effect until 5:00 p.m. on November 1, 2000.

IT IS SO ORDERED.

DATED: October 30, 2000

DAVID O. CARTER

UNITED STATES DISTRICT JUDGE
