UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

U.S. SECURITIES AND EXCHANGE COMMISSION,	)	
Plaintiff,	)	**Civil Action No. 18-CV-5587**
v.	)	**Judge John Z. Lee**
EQUITYBUILD, INC., *et al.*,	)	**Magistrate Judge Young B. Kim**
Defendants.	)	

SEC'S REPLY IN SUPPORT OF RECEIVER'S MOTION FOR APPROVAL OF PROCESS FOR RESOLUTION OF DISPUTED CLAIMS

The SEC supports the Receiver's Motion for Approval of Process for Resolution of Disputed Claims (ECF No. 638). The process the Receiver seeks to implement is the culmination of three in-chambers conferences where the Court heard the positions of the Receiver, institutional lenders, certain investors, and the SEC before directing the parties on how to proceed. The Receiver's proposal is entirely consistent with the Court's guidance. The proposal also reflects the Receiver's reasonable business judgment on how to efficiently and equitably resolve competing claims in a manner that provides fairness and due process to all claimants. The Receiver's proposal is likewise consistent with a long line of Seventh Circuit cases affirming a receiver designing and implementing distribution plans that result in certain classes of creditors receiving claims priority as opposed to other creditors.

For these reasons, those discussed below, and those advanced by the Receiver, the Court should grant the Receiver's motion and allow the claims resolution process to proceed.

A. Background

As the Receiver notes in his motion, his proposed process seeks to resolve the competing priority claims of two classes of secured creditors. The first class consists of the defrauded investor-victims of the Cohens' Ponzi scheme. In connection with their investments, these investors received recorded mortgages as security for their investments. The other class of creditors are the institutional lenders, who later provided refinancing to the Cohens and also received mortgages on the very same properties secured by the earlier-recorded mortgages of the investors. (*See, e.g.*, ECF No. 638, p. 4).

There has been no allegation, even by the institutional lenders, that the investors voluntarily released their mortgages or were otherwise compensated when the lenders recorded their subsequent mortgages. Thus, the priority disputes will generally involve the same factual and legal issues: whether the earlier recorded mortgages of the uncompensated and defrauded investors are trumped by the later recorded mortgages of the institutional lenders.

A likely key and recurring issue for the Court to decide is the application of the "*bona fide* purchaser" doctrine vis-à-vis any mortgage releases or payoff statements effected by the Cohens without authorization or consent by the investors. *See, e.g.*, *M&T Bank v. Mallinckrodt*, 43 N.E.3d 1039, 1041, 1049-50 (Ill. App. Ct. 2015) (denying summary judgment on lien priority determination, where issues of fact existed on whether subsequent secured lender reasonably relied on fraudulent payoff statement for earlier mortgage); *see also Mitchell v. Sherman E. McEwen Assocs., Inc.*, 196 N.E. 186, 189 (Ill. 1935) ("Where the prior legal owner is wholly innocent, has neither done nor omitted to do anything, it is inequitable to sustain the claims of a subsequent holder even though he be also a *bona fide* purchaser.").

Another recurring issue the Court may address is whether any of the mortgages at issue – including the investors' and lenders' mortgages – are voidable fraudulent transfers. *In re Sentinel Mgmt. Grp.*, 809 F.3d 958, 960-64 (7th Cir. 2016) (secured loan invalid when it constituted a fraudulent transfer).

B. The Receiver's Proposal

The Receiver's proposal results from three in-chambers conferences where the Receiver, lenders, investors, and the SEC were provided ample opportunities to seek the Court's guidance and present their positions on how the priority determination process should proceed. (*See*, ECF Nos. 565, 586, 625). The Receiver's current proposal was vetted at the most recent of these conferences, occurring January 30, 2020, and reflects processes and procedures for which the Court voiced its approval.[1] As noted in the Receiver's motion, all claimants have already received notice of the Receiver's proposal and have been given the opportunity to object. (ECF No. 638, ¶ 28). The specifics of the Receiver's proposal are as follows:

- The Court would issue an order apprising all claimants to a property that a priority dispute exists. (ECF No. 638, ¶ 29). That order would affirm that the proofs of claim, which have already been submitted, would serve as the complaints for the priority resolution process. (*Id.*, ¶ 30). Presumably, this would trigger the lenders' title insurance.[2]

- The priority disputes would be grouped into tranches based on the institutional lenders asserting claims on the subject properties. (*Id.*, ¶ 31). This assures that the disputes would solely involve investors, on one hand, and a single institutional lender, on the other.

- For each tranche, the Receiver will file a "framing report," which identifies all of the claimants for the subject properties and, presumably, the grounds on which the various

[1] At those three conferences, the lenders advocated that priority should be determined through a large bundle of independent declaratory judgment actions pitting the lenders against the investors. The Court rejected that proposal.

[2] The SEC understands that, unlike the defrauded investors, the lenders have title insurance that could compensate them for losses stemming from the priority determination process.

claimants assert priority and any issues the Receiver believes should be addressed in the claimants' position papers. (*Id.*, ¶ 32). In preparing the framing report and throughout the priority determination process, the Receiver will *act as a neutral* and not represent or advocate on behalf of any claimant or set of claimants. (*Id.*, ¶ 37). The framing report, coupled with the claims that serve as the complaints, will provide all claimants notice of the factual and legal issues that the Court will need to resolve to determine priority and should be addressed in discovery.

- In terms of discovery, all claimants for each tranche will have access to all claims in the tranche and any supporting documentation filed with the claims. (*Id.*, ¶¶ 33, 35, 36). To ensure efficiency, the only parties that would participate in discovery would be the claimants for that tranche, the Receiver, and the SEC. (*Id.*, ¶ 38). Expedited 60-day discovery would proceed with each claimant being entitled to 10 interrogatories, 10 document requests, and three depositions. (*Id.*). The only third-party discovery recipients would be title insurance companies. (*Id.*). These discovery procedures precisely follow the Court's guidance from the most recent in-chambers conference.

- Within 21 days after discovery closes, the claimants would file position papers with the Court. (*Id.*, ¶ 39). The Receiver, *acting as a neutral*, would then file a position paper containing his views as to priority determination. (*Id.*, ¶ 40). The claimants would then file responses to the Receiver's and other claimants' position papers. (*Id.*, ¶ 41). This ensures that each claimant, after being fully apprised of the other claimants' and Receiver's positions, gets to "have the last word" with the Court.

- The Court, in its discretion, may conduct an evidentiary hearing to resolve factual disputes before making its priority determination. (*Id.*, ¶ 42). In any event, the Court's priority determinations will have no preclusive effect on the claimants outside the tranche at issue. (*Id.*, ¶ 43). Thus, claimants outside of each tranche will suffer no prejudice by not participating in that tranche.

- The Receiver will be reimbursed for his efforts in the process, and will be paid from the sales proceeds of each property. (*Id.*, ¶¶ 52-57). In this way, *only the winners* of the priority determinations will be required to compensate the Receiver for his work on the particular property at issue.

- The first proposed tranche will involve a single institutional lender, 185 investors, and five properties. (*Id.*, ¶ 49). This modestly size tranche involves a limited number of properties, claimants, and issues, which should allow the initial priority determinations to be made in a manageable and efficient manner.

C. The Receiver's Proposal is Reasonable, Prudent, and Consistent with Precedent

"In supervising an equitable receivership, the primary job of the district court is to ensure that the proposed plan of distribution is fair and reasonable." *SEC v. Wealth Mgmt. LLC*, 628

F.3d 323, 332-33 (7th Cir. 2010) (citations omitted). The Court "has broad equitable power in this area," such that the Court's approval of a receiver's proposal is reviewed under an abuse of discretion standard. *Id*; *see also SEC v. Enterprise Trust Co.*, 559 F.3d 649, 652 (7th Cir. 2009); *SEC v. Huber*, 702 F.3d 903, 908 (7th Cir. 2012) ("The cases treat the receiver's choice among allocation schemes as one within the discretion of the district court to approve or disapprove, like other aspects of the administration of a receivership."); *Duff v. Central Sleep Diagnostics, LLC*, 801 F.3d 833, 841 (7th Cir. 2015) ("we review the court's decision approving the [receiver's] distribution plan deferentially").

In considering a receiver's distribution proposal, the Court starts "with the principle that where investors' assets are commingled and the recoverable assets in a receivership are insufficient to fully repay the investors, 'equality is equity.'" *Wealth Mgmt.*, 628 F.3d at 333 (quoting *Cunningham v. Brown*, 265 U.S. 1, 13 (1924)). For instance, to allow a receiver to "classify claims sensibly," a receiver's distribution plan may appropriately "subordinate the claims of certain investors to ensure equal treatment." *Wealth Mgmt.* at 333 (citations omitted). This includes giving preference to investors who "did not authorize [the defendant] to change or pledge their assets in any way…were in the dark about the fact that [defendant] had used their assets as collateral [and] had been subjected to involuntary and uncompensated risk." *Enterprise Trust*, 559 F.3d at 652. Similarly, receivers "can displace even *prior* security interests in receivership property in some circumstances." *Duff*, 801 F.3d at 842 (emphasis in original). To ensure the equitable treatment of creditors, the Court may deviate from state law. *Wealth Mgmt.* at 333-34 (approving pro-rata distribution that subordinated certain investors' claims).

Against this backdrop, the Receiver proposes reasonable and equitable procedures to determine the priority of the competing claimants. Per the Receiver's proposal, all claimants are entitled to meaningful discovery (after being provided with the Receiver's framing report) and to make at least two written submissions to the Court, including the opportunity to respond to the Receiver's and the other claimant's position papers. The Court, not the Receiver, will ultimately decide who has priority, with the Court's decision having no preclusive effect on subsequent priority determinations for claimants in later tranches.

While the institutional lenders may prefer alternative procedures, they cannot show that the Receiver's proposal lies beyond the Court's broad equitable powers to supervise a Receivership or deprives claimants of the "touchstones" of due process: "Notice and an opportunity to be heard." *Simer v. Rios*, 661 F. 2d 655, 667 (7th Cir. 1981). Nor can the lenders establish that the Receiver's proposal falls beyond his reasonable business judgment to implement a claims and distribution process in an efficient and equitable manner. *See, e.g.* ECF No. 676, p. 4 (the Court "does not intend to dictate the Receiver's every move, absent a showing that he is exceeding his [broad grant of] authority or otherwise violating the Receivership Order." (citations omitted)).

D. The Lenders' Objections Are Unavailing

The lenders lodge six primary objections to the Receiver's proposal. As discussed below, none of the objections demonstrate that the Receiver's proposal falls outside the Court's broad equitable powers or the Receiver's reasonable business judgment.

First, the lenders complain that the Receiver's proposal allows him to assert third-party actions against the lenders – most notably claims for fraudulent transfer – outside of the priority

determination process.[3] This objection ignores that the Receiver's proposal calls for him to file his position with the Court and allows the lenders an opportunity to respond. Presumably, if the Receiver believes that the elements of fraudulent transfer are satisfied, he will apprise the Court in his position paper and the lenders will be able to argue otherwise. The Court will then decide, if necessary, whether grounds exist to void any mortgages. There accordingly should be no reason for the Receiver to assert independent fraudulent transfer claims against the lenders (or investors) outside of the priority determination process.

While the lenders complain they will not have the opportunity to take discovery after the Receiver files his position papers, the lenders currently are well aware that potential fraudulent transfers are an issue in these proceedings. And the lenders will obtain even greater insight via the Receiver's pre-discovery framing reports. The lenders will have ample opportunity to explore such issues in discovery. Thus, streamlining the process to allow the Receiver to address potential fraudulent transfers, along with other issues affecting lien priority, does not implicate due process concerns.

Second, the lenders complain the Receiver's proposal does not provide them adequate notice. Specifically, the lenders object to the proposal that all claimants' previously-filed claims submissions serve as the complaints in the priority determination process. In claiming lack of due process, the lenders ignore that they will have the opportunity to file responses with the Court *after* the other claimants and Receiver have filed their position papers (which would be required to document any objections that exist to the lenders' claims of priority). The lenders

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[3] If the requisite elements are satisfied, the lenders' or investors' mortgages, even if otherwise found to have priority, may be voidable as fraudulent transfers. *In re Sentinel Mgmt. Grp.*, 809 F.3d 958, 960-64 (7th Cir. 2016) (secured loan invalid when it constituted a fraudulent transfer). This could be the case if the Equitybuild affiliates entered the investors' or institutional lenders' mortgages on the eve of insolvency and with the intent to "hinder, delay, or defraud another creditor." *Id.* at 964 (citations omitted).

will thus receive *written notice* of the other parties' positions and have an opportunity to be *heard in writing*, at minimum, as well as at an evidentiary hearing if the Court deems it appropriate. Of course, the filing of position papers will occur after all claimants receive the other claim submissions and have the opportunity for discovery. This readily satisfies traditional notions of due process, even in the absence of a Rule 8 complaint. *See, e.g., SEC v. Elliott*, 953 F.2d 1560, 1567 (11th Cir. 1992) ("a district court does not generally abuse its discretion if its summary procedures permit parties to present evidence when the facts are in dispute and to make arguments regarding those facts.").

On the other hand, not requiring the filing of formal complaints is entirely consistent with the Court's guidance. Indeed, the lenders have repeatedly requested that the Court require the filing of independent declaratory judgment actions to determine priority – a proposition the Court has repeatedly rejected. As discussed at the in-chambers conferences, requiring the defrauded investors to initiate (or defend against) independent lawsuits would be cost-prohibitive for many and contrary to the equitable nature of the receivership.[4] And, mandating that all claimants "state their position at the start of the process" (Response at 10) could prejudice the investors, who would be required to *ex ante* raise all challenges to the institutional lenders' liens without the benefit of taking discovery.

Third, the lenders object that the Receiver's proposal does not provide adequate discovery. But the lenders ignore that the Court, not the Receiver, determined the expedited

[4] The lenders argue that the "average" claim is $150,000 and will motivate the claimants to litigate. (Response at 10). But citing the "average" claim necessarily means that many investors are submitting much smaller claims, especially given that the institutional lenders are submitting claims much larger than those of the investors. To that end, the list of claims attached to the Receiver's motion reflects that a significant number of investors submitted claims of less than $10,000. (ECF No. 638, Ex. 1). Conversely, the institutional lenders' claims typically exceed $1 million, often by substantial amounts. (*Id.*).

discovery procedures at the conclusion of the January 30, 2020 in-chambers conference. The Court's decision to adopt expedited discovery procedures is well within its discretion to limit the default discovery provisions of the Federal Rules of Civil Procedure. *See* F.R.C.P. 26(b)(2) ("By order, the court may alter the limits in these rules…").

The lenders' challenges to the Court's discovery procedures also run contrary to the lenders' position earlier in this litigation. In particular, in response to the Receiver's initial motion to establish the claims process, the lenders filed an objection requesting "immediate" discovery relating to lien priority and "expedited" priority determinations. (ECF No. 285, p. 2). Given their earlier demands for expedited discovery, the lenders' current complaints of insufficient discovery ring hollow.

The lenders also argue that the Court's procedures would prevent the lenders from obtaining Equitybuild's business records that are now in the Receiver's position. But nothing in the Court-directed discovery procedures or the Receiver's proposal prevents the lenders from serving discovery requests on the Receiver or obtaining his relevant documents. Thus, the discovery provisions outlined by the Court and reflected in the Receiver's proposal provide sufficient and proportional process that balances all claimants' needs for discovery to proceed in a focused and cost-effective manner.

Fourth, the lenders object that the Receiver's proposal does not precisely define whether an evidentiary hearing will occur and, if so, the parameters for how that hearing should proceed. However, the Receiver's process allows for the claimants to request a hearing and advocate for procedures to govern the hearing. (ECF No. 638, ¶ 42). The Court, in its discretion, will then determine whether a hearing is necessary. (*Id.*). Should the Court decide that a hearing would assist its priority determinations, the Court is certainly capable of deciding on procedures to

govern the hearing that would ensure fairness and due process. *Elliott*, 953 F.2d at 1568 ("The structure of the hearing is left to the discretion of the district court so long as the [parties] can present and argue their facts.").

Fifth, the lenders object to the Receiver's and the SEC's proposed roles in the priority determination process. Again, the lenders ignore that the Receiver's proposal, including the respective roles of the Receiver and SEC, precisely tracks the Court's guidance following the January 30, 2020 in-chambers conference. The lenders had many opportunities to, and in fact did, object – yet the Court correctly decided that the Receiver and SEC should be involved.

Regarding the Receiver, the lenders argue that the Receiver will impermissibly advocate on behalf of the investors. But the Receiver has repeatedly represented to the Court that he will act as a neutral in presenting his framing reports and position papers to the Court. The lenders counter that the Receiver cannot act as a neutral if he takes discovery. (Response at 16). To the contrary, participating in the discovery process serves an entirely valid purpose: allowing the Receiver to gain as much information as he feels necessary to fulfill his role of objectively assisting the Court in its priority determinations. *See, e.g., James v. Concepcion*, 1997 U.S. Dist. LEXIS 13031, *7-8 (N.D. Ill. Aug. 28, 1997) ("the rationale for the existence of the discovery rules [is] the search for truth"); *Anderson v. Cornejo*, 2001 U.S. Dist. LEXIS 10312, *14 (N.D. Ill. July 20, 2001) (discovery process facilitates "the search for truth").

Offering no evidentiary support, the lenders fear the Receiver will only support the investors' claims. Not so. Rather, the Receiver has represented that he will impartially evaluate the competing claims and apprise the Court of his position. Thus, if an objective application of the facts and law supports the lenders' claims, even to the detriment of investors, the Receiver

will be bound to apprise the Court of that determination.[5]

The lenders also argue that the Receiver's proposal impermissibly positions the Receiver as a judicial officer. These objections ignore that receivers routinely make recommendations to courts that favor certain types of creditors over another. *See, e.g., Wealth Mgmt.*, 628 F.3d at 332-334 (affirming receiver's distribution plan that favored one class of claimants over another); *Huber*, 702 F.3d at 908-09 (same result); *Duff*, 801 F.3d at 844 (same result and holding: "To treat the claimants equally across the board, the final distribution plan reasonably excluded claim amounts attributable to penalties, interest, and attorney's fees."). As in these decisions, the Receiver's proposal recommends that he will make *neutral* submissions to the Court, and the Court will make its priority determinations *de novo*.

As for the lenders' complaints that the SEC should not participate in the process, the lenders gloss over the fact that unlike any of the claimants, the SEC is actually a party to this litigation.[6] As such, the SEC is entitled to advocate for equitable distributions. *Huber*, 702 F.3d at 908 (there "is even authority for allowing a district court, at the behest of the SEC when it is a party to a suit…to enjoin investors and other creditors from filing a bankruptcy action if that would interfere with the SEC's pursuit of equitable remedies."). While the SEC will not represent or advocate for any specific claimant, it intends to monitor and, if necessary,

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[5] The lenders argue that the Receiver cannot be impartial because he has opposed certain of their motions. (Response at 16 n. 10). While the Receiver has opposed the lenders' proposals as to *process*, he has repeatedly reserved judgment on the *substance* of all priority determinations. *See, e.g. Elliott*, 953 F.2d at 1577 ("The appellants argue that the Receiver is an adverse party and all of his work was to deprive the appellants of their secured interest. This is not exactly true, for the Receiver is an officer of the court… Even though the Receiver may at times take adverse positions to certain claimants, the Receiver acts under supervision of the court…for the court must independently approve the Receiver's legal and factual findings.") (citations omitted).

[6] Because the SEC is a party, the lenders' arguments regarding the SEC's inability to intervene carry no weight.

participate to ensure that the *process* is fair and equitable for all claimants. This includes the large numbers of defrauded investors who may lack the means, sophistication, or financial incentive to further litigate the issue of priority.

It is notable that in arguing the SEC is straying beyond enforcing the securities laws and regulating financial markets, the lenders ignore that a core mission of the SEC is "to protect investors." https://www.sec.gov/about.shtml. Given the wide disparity in resources between the lenders and many of the defrauded investors, excluding the SEC from the claims process would prevent the SEC from fulfilling a central mandate to protect the rights of investors and ensure they receive fair and equitable process, regardless of how the Court ultimately rules on priority.

Sixth, the lenders argue that the Receiver should not be entitled to reimbursement for his efforts in the priority determination process. But even the lenders concede that a court may appropriately "impose a lien on property in a receivership to satisfy the receivership expenses" and "in its discretion, determine who shall be charged with the costs of the receivership." *Gaskill v. Gordon*, 27 F. 3d 248, 251 (7th Cir. 1994) (prioritizing receiver expenses over secured lienholders); *see also Duff*, 801 F.3d at 842 ("Receivers can displace even *prior* security interests in receivership property in some circumstances.").

Here, the Court has repeatedly affirmed that the Receiver's work has "benefitted and will continue to benefit the Receivership Estate." (*See, e.g.,* ECF No. 710, p. 3; ECF 614, p. 3). In doing so, the Court has continued to approve expenses for the Receiver's work (a) designing and implementing the claims process; and (b) maintaining, marketing, and liquidating the properties whose sales proceeds will be distributed to senior secured claimants. Given the Court's finding and guidance that the Receiver's work is beneficial, the Receiver should be allowed to continue his work and be compensated for his efforts. On the other hand, acquiescing to the lenders'

demands that the Receiver not be paid would effectively nullify the Receiver's role in the claims and priority-determination process – a request that the Court has repeatedly rejected.

Finally, the lenders complain that they should not be required to pay the Receiver if he advocates against them. But under the Receiver's proposal, the only claimant that would pay for his work on the priority-determination process would be claimant the Court ultimately finds to have priority. Thus, only the "winners" of the process, be they the lenders or investors, will be required to remit a portion of the property sales proceeds to the Receiver. The "losers" will not pay the Receiver anything. *See, e.g., Elliott*, 953 F.2d at 1577 ("Although the prevailing secured claimant had to fight the Receiver's opposition to his claim, he reaped benefits when the Receiver defeated competing claims. By combatting competing claims, the Receiver became his ally. We find that, with these type of activities, the Receiver conferred a benefit on the secured creditors and merits fees from their collateral.")

E. Conclusion

The Receiver's priority determination proposal follows the Court's guidance resulting from three in-chambers conferences in which the institutional lenders participated and voiced their position. The proposal is well within the Court's equitable authority and discretion. And the proposal is consistent with numerous Seventh Circuit decisions where receivers had active involvement in designing and implementing distribution plans that ultimately favored one class of creditors at the expense of others. Accordingly, the lenders' objections lack merit and the Court should grant the Receiver's motion and allow the priority determination process to proceed.

Dated: June 22, 2020

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that I provided service of the foregoing Reply, via ECF filing, to all counsel of record and Defendant Shaun Cohen, on June 22, 2020. I further certify that I caused the foregoing Response to be served on Defendant Jerome Cohen, via email at jerryc@reagan.com.

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