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UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF CALIFORNIA – SAN FRANCISCO

CONSOLIDATED MANAGEMENT GROUP, LLC, a Kansas limited liability company; CONSOLIDATED LEASING ANADARKO JOINT VENTURE, a Kansas general partnership; and CONSOLIDATED LEASING HUGOTON JOINT VENTURE #2, a Kansas general partnership, Plaintiffs, vs. PRESTON DuFAUCHARD, California Corporations Commissioner; and CALIFORNIA DEPARTMENT OF CORPORATIONS. Defendants.	Case No.: C 06-4203-JSW MEMORANDUM OF POINTS AND AUTHORITIES IN SUPPORT OF OPPOSITION TO PLAINTIFFS' MOTION FOR A PRELIMINARY INJUNCTION DATE: September 8, 2006 TIME: 9:00 a.m. DEPT: Courtroom 2, 17th Floor JUDGE: Hon. Jeffrey S. White **FILED VIA E-FILING**

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MEMORANDUM OF POINTS AND AUTHORITIES IN SUPPORT OF OPPOSITION TO PLAINTIFFS' MOTION FOR A PRELIMINARY INJUNCTION

The defendants, Preston DuFauchard, California Corporations Commissioner, and the California Department of Corporations ("Department") submit the following Memorandum of Points and Authorities in support of their Opposition to plaintiff's motion for a preliminary injunction. In Opposition, defendants refer to and incorporate by reference the Motion to Dismiss pursuant to Rule 12(b)(6), filed August 27, 2006, the Administrative Decision attached as Exhibit 1 to that motion, and the facts and arguments contained therein, which also supports defendants' position that plaintiffs failed to state any facts to support an injunction in this case.

A. INTRODUCTION.

There is no justification for an injunction in this case. Plaintiffs argue that because they have performed all the formal filing requirements to make a private offering of securities in California, the Commissioner, and, therefore the Department, is preempted by federal law from conducting any investigation with regard to potential violations of the private offering exemption. The plaintiffs have, however, been found after an administrative evidentiary hearing to have failed to conform their conduct in marketing these securities to the requirements of the exemption; they made a public offering of unqualified securities instead of limiting themselves to the strictures of a private offering. This finding confirmed the information that caused the Commissioner to issue the administrative Desist and Refrain ("D&R") Order in the first place. The Order demanded that plaintiffs either discontinue the sales without qualifying them as required by California law, or comply with the terms of the exemption that the plaintiffs relied upon. Since plaintiffs' conduct caused the transaction to lose the private offering exemption and the related preemption of further action by the Commissioner, they have no claim under federal law. The Court should not issue an injunction preventing the action of the Commissioner from taking effect.

B. STATEMENT OF FACTS.

As alleged in plaintiffs' complaint, in August of 2005 and again in November of 2005, plaintiffs filed a "Form D" exemption with the Commissioner in order to sell securities in California without state qualification pursuant to California Corporations Code §25102.1. This Form D,

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pursuant to Regulation D of the Securities Act of 1933, had previously been filed with the Securities and Exchange Commission. In order to qualify for an exemption pursuant to Regulation D, the applicant cannot offer securities by any form of general solicitations or general advertising. *Regulation D, Rule 506, 17 C.F.R. §230.506.*

Almost immediately following the plaintiffs' filings, the Department of Corporations learned that plaintiffs offered the securities by way of mass mailings and seminars where the potential investors who attended had no pre-existing relationship with the offeror plaintiffs. Therefore, the Department determined that the plaintiffs were violating the terms of the Regulation D exemption and were in violation of state qualification requirements. In their Complaint, plaintiffs do not allege any facts to demonstrate they acted in compliance with Regulation D.

On January 23, 2006, the Commissioner issued a Desist and Refrain Order ("D&R") to Kenneth W. Keegan, Faber Lane Johnston, Brandon Taylor, Guardian Capital Management, Consolidated Management Group, LLC, Consolidated Leasing Anadarko Joint Venture, and Consolidated Leasing Hugoton Join Venture #2. The D&R alleged violations of the California Corporations Code, sections 25110 and 25210. These violations were alleged because plaintiffs were not licensed to sell securities with the Department and, because of their general solicitations and advertisements, they failed to qualify for the Regulation D exemption from state qualification.

Plaintiffs requested an administrative hearing on the Order, which was held on March 6-7, 2006. The Administrative Law Judge issued his proposed Decision, which was adopted by the Commissioner and became effective July 20, 2006. A true and correct copy of the Decision is attached as Exhibit 1 to defendants' motion to dismiss and as Exhibit 12 to plaintiffs' motion for a preliminary injunction. Plaintiffs have a right to appeal from this Decision to the California Superior Court. At the time of this writing, the time for plaintiffs to seek an appeal from the Administrative Law Judge has not expired. However, as more fully explained below, this Court should not allow plaintiffs to relitigate the conclusion of the Administrative Law Judge that the offering of plaintiffs was a security in California, or that plaintiffs violated the requirements of Regulation D in the conduct of their offering activities.

By failing to state they have met the essential elements of the requirements for the exemption

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they seek, plaintiffs cannot claim the benefits of the exemption in this federal court action, and the authority of the state regulator is not, as a matter of law, preempted. As a result, plaintiffs failed to state facts that would give rise to a claim in federal court and the action does not support injunctive relief.

C. LAW AND ARGUMENT.

1. PLAINTIFFS FAILED TO ALLEGE FACTS THAT THEY HAVE SUFFERED A SIGNIFICANT THREAT OF IRREPARABLE INJURY, OR THAT THE BALANCE OF HARDSHIPS FAVORS THE INJUNCTION THEY SEEK, OR WHETHER THEY HAVE A LIKELIHOOD OF PREVAILING, OR WHETHER ANY INTEREST FAVORS GRANTING AN INJUNCTION, SO THE REQUEST SHOULD BE DENIED.

"The traditional test for granting preliminary injunctive relief requires the applicant to demonstrate: (1) a likelihood of success on the merits; (2) a significant threat of irreparable injury; (3) that the balance of hardships favors the applicant; and (4) whether any public interest favors granting an injunction. *Dollar Rent A Car of Wash., Inc. v. Travelers Indem. Co.*, 774 F.2d 1371, 1374 (9th Cir. 1985). The Ninth Circuit also uses an alternative test that requires the applicant to demonstrate either a combination of probable success on the merits and the possibility of irreparable injury, or serious questions going to the merits and that the balance of hardships tips sharply in the applicant's favor. *First Brands Corp. v. Fred Meyer, Inc.*, 809 F.2d 1378, 1381 (9th Cir. 1987). The two tests represent a continuum of equitable discretion, whereby "the greater the relative hardship to the moving party, the less probability of success must be shown." *Nat'l Center for Immigrants Rights, Inc. v. INS*, 743 F.2d 1365, 1369 (9th Cir. 1984). *Covarrubias v. Ralph's Grocery Co.*, 2004 U.S. Dist. LEXIS 18318, 4-7 (D. Cal. 2004).

The D&R Order was issued on January 9, 2006. The administrative hearing was conducted over March 6 and 7, 2006, after which a Decision was issued by the Administrative Law Judge in favor of the Commissioner and against the plaintiffs. That Decision became effective July 20, 2006. If plaintiffs really believed that the action of the Commissioner was preempted by its filing of Regulation D notices and that the Commissioner had no power to issue the administrative order, any "hardship" would have occurred immediately upon service of the D&R Order. Plaintiffs' delay of more than seven months before seeking an injunction belies the sense of urgency they attempt to present in this court.

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Plaintiffs failed to allege any facts supporting their request for injunctive relief. The Declaration of Mr. McNaul simply states in general language that the "Consolidated Parties have lost an unquantifiable amount of business opportunities and revenues," they have "suffered harm to their business reputation and goodwill" and "had to lay off numerous employees." It would seem that after seven months, the "Consolidated Parties" would know the value of the "business opportunities and revenues" that supposedly have been lost. They would also know the value of the loss of "business reputation and goodwill" and they would know just how many of the "numerous" employees were laid off. This vague description of supposed harm does not support injunctive relief in this case.

All the D&R Order requires is that plaintiffs either comply with the federal exemption they claim their sales fall under, or register/qualify the security by filing the appropriate paperwork in California. If plaintiffs comply with the terms and conditions of the Section 506 exemption, they will also be exempt under Corporations Code §25102.1 and they can continue to sell the investments in the state. The Commissioner's Order simply requires Consolidated to comply with federal exemption conditions. This should be no burden at all because plaintiffs should be in compliance anyway.

Consolidated cites *Wells Fargo Bank vs. Boutris* 252 F. Supp.2d 1065 (9th Cir. 2005) and *Gerling Global Reins. Corp. v Quackenbush*, 2000 U.S. District LEXIS 8815, in an attempt to support their argument that they will suffer irreparable harm if the Commissioner is not enjoined. In *Wells Fargo Bank* the issue was whether WFHMI, a subsidiary of Wells Fargo, was entitled to the preemption federal banking law provided for federally regulated national banks. The Commissioner did not dispute that the parent company Wells Fargo, a national bank, was entitled to the preemption. In that case the Commissioner sought to enjoin WFHMI, the subsidiary, from violating various state regulatory requirements that were different from federal regulatory requirements. The court concluded that the subsidiary was entitled to the same preemption as its parent and that WFHMI need only comply with federal requirements.

Unlike the *Wells Fargo Bank* case, the Commissioner here is seeking to compel Consolidated to comply with state requirements, specifically §25102.1, that provides an exemption only upon meeting the federal Regulation D requirements. The Commissioner does not dispute that there would be preemption if Consolidated's offers and sales of securities in this state conform to these federal

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exemption restrictions, a preemption that would preclude the Commissioner from imposing additional registration requirements, but there is no preemption protection if Consolidated is not complying with those Regulation D restrictions. Moreover, there is no burden to Consolidated, as there was to WFHMI in *Wells Fargo Bank*, of having to comply with conflicting state laws or regulations. The law the Commissioner refers to in the Order is one that obligates Consolidated to comply with the conditions of a Regulation D offering that Consolidated cannot dispute it must follow anyway. Unlike the plaintiffs in *Wells Fargo Bank* and *Quackenbush*, the only burden to Consolidated is that it must comply with the conditions of the exemption it claims preempts state registration, and that certainly cannot be considered "irreparable harm."

Plaintiffs assert that even if they were not in compliance with the very exemption they claim preempts the Commissioner's action, there is still some preemptive effect. However, plaintiffs must still comply with the conditions of the Rule 506 exemption, or they cannot claim their sales fell within its provisions, nor can they claim the Commissioner is pre-empted from looking at how plaintiffs conducted the sales activities. Moreover, since it has now been decided by a trier of fact in the administrative hearing that plaintiffs did not, in fact, comply with the requirements of the 506 exemption by conducting general solicitation sales activities among other things, they cannot now claim the preemption, nor can they assert with any credibility that they are entitled to an injunction. As a result, plaintiffs cannot demonstrate a likelihood of success on the merits.

The balance of hardships does not favor plaintiffs, but favors the Commissioner on behalf of the investing public. The public interest of the Commissioner should prevail over the narrow interest of plaintiffs in seeking to sell their investments in California in violation of applicable qualification/registration requirements.

2. SINCE PLAINTIFFS INITIATED THE ADMINISTRATIVE PROCESS RESULTING IN A FINDING OF FACT THAT PLAINTIFFS FAILED TO COMPLY WITH THE REQUIREMENTS OF THE RULE 506 EXEMPTION AND A CONCLUSION OF LAW THAT THEY WERE OFFERING SECURITIES IN CALIFORNIA, THEY SHOULD NOT BE ALLOWED TO RELITIGATE THESE FINDINGS IN THIS COURT.

The Decision of the Administrative Law Judge has been adopted by the Commissioner. The findings were that plaintiffs were offering securities under California law and that plaintiffs failed to comply with the conditions of the Rule 506 exemption. Plaintiffs should be barred from relitigating

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the underlying facts or seeking contrary conclusions of law. In an order granting a motion for summary judgment, the court in *Gayle v. County of Marin* found:

> Title 28 U.S.C. § 1738 requires that federal courts give State court judgments the same preclusive effect as federal judgments. As a matter of federal common law, the fact-finding of a State agency, acting in a judicial capacity in a proceeding where "the parties have had an adequate opportunity to litigate," is also given preclusive effect. *Univ. of Tenn. v. Elliott*, 478 U.S. 788, 799, 106 S. Ct. 3220, 92 L. Ed. 2d 635 (1986) (quoting *United States v. Utah Construction & Mining Co.*, 384 U.S. 394, 422, 86 S. Ct. 1545, 16 L. Ed. 2d 642, 176 Ct. Cl. 1391 (1966)). *Gayle v. County of Marin*, 2005 U.S. Dist. LEXIS 40514, 9-10 (D. Cal. 2005)
>
> The Ninth Circuit has extended *Elliot* to give preclusive effect to "state administrative adjudications of legal as well as factual issues, as long as the state proceeding satisfies the requirements of fairness outlined in [*Utah Construction*]." *Miller v. County of Santa Cruz*, 39 F.3d 1030, 1032-33 (9th Cir. 1994) (quoting *Guild Wineries and Distilleries v. Whitehall Co.*, 853 F.2d 755, 758 (9th Cir. 1988)). Those fairness requirements are "(1) that the administrative agency act in a judicial capacity, (2) that the agency resolve disputed issues of fact properly before it, and (3) that the parties have an adequate opportunity to litigate." Id. (citing *Utah Construction*, 384 U.S. at 422); see also *Mack v. South Bay Beer Distributors, Inc.*, 798 F.2d 1279, 1283-84 (9th Cir. 1986) (no preclusive effect afforded to informal unemployment benefits hearing because the plaintiff did not have an adequate opportunity to litigate factual issues related to discrimination).
>
> The Ninth Circuit found that California has adopted the *Utah Construction* standard, and therefore that federal courts need only look at "whether the administrative hearing met the requirements of California law such that a California court would have accorded the determination preclusive effect." *Id.* at 1033 (citing *Eilrich v. Remas*, 839 F.2d 630, 633 (9th Cir. 1988)). *Gayle v. County of Marin*, *supra,* at pp. 11-12.

The administrative hearing in this matter was conducted over two days in March 2006. Plaintiffs attended and were well represented by counsel, as indicated in the transcripts attached to plaintiffs' motion. They were not prevented from introducing any evidence. In fact, they vigorously asserted defenses to the Commissioner's Order, as the administrative record reflects. The finding of fact was that plaintiffs offered the investments by general solicitations, cold calls to people that did not have a relationship with the issuer or sales force, and by way of seminars attended by people who were not accredited investors as required. A conclusion of law was that the investment opportunities offered by plaintiffs constituted a security under California law. Under *Gayle*, plaintiffs should not be able to relitigate this the underlying facts or seek contrary conclusions of law.

Similarly, in *Miller v. County of Santa Cruz*, 39 F.3d 1030, 1032-33 (9th Cir. 1994), the court affirmed an order granting a summary judgment, where the plaintiff had an opportunity to contest a dismissal from his employment before a county civil service commission in a public evidentiary

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hearing. In doing so, the court stated:

> We affirm the judgment of the district court. In so doing, we reiterate our longstanding policy, arising out of concerns of comity and finality, of respecting state court systems for review of administrative decisions. *Eilrich [v. Remas]*, 839 F.2d at 633 [(9th Cir. 1988)]. California has made it quite clear that a discharged civil servant who elects an administrative forum for review of his or her termination must succeed in overturning that administrative decision through the judicial mandamus review procedure prior to filing a suit for damages on claims arising out of the termination. *See, e.g., Swartzendruber [v. City of San Diego]*, 5 Cal. Rptr. 2d at 69. So long as the minimum criteria of *Utah Construction* are met, we will defer to the considered judgment of the courts of California that an unreviewed agency determination, such as that involved here, is equivalent to a state court judgment entitled to res judicata and collateral estoppel effect. Any other result would render the administrative forum a place for meaningless dry runs of wrongful termination claims destined to be assailed on constitutional grounds in federal court. *Miller v. County of Santa Cruz, at* 1038.

There is little question that the administrative process in this case met the "minimum criteria" of the relevant authorities. In this case, the administrative agency acted in a judicial capacity, it resolved the disputed issues of fact properly before it, and the parties, particularly plaintiffs, had an adequate opportunity to litigate. The fact that plaintiffs chose to initiate the administrative hearing process should further emphasize the collateral estoppel effect of any findings of fact or conclusions of law, precluding the plaintiffs from relitigating these factual and legal issues in this court.

3. NSMIA DOES NOT PREEMPT THE COMMISSIONER BECAUSE THE TRANSACTION WAS NOT EXEMPT UNDER REGULATION D SO INJUNCTIVE RELIEF SHOULD BE DENIED.

Section 5 of the Securities Act, codified in 15 U.S.C. §77e provides that before a security is sold through the mail or through interstate commerce the security must be registered with the SEC. Under 15 U.S.C. §77c and d certain securities and transactions are exempted from this registration requirement, and in relevant part §77d(2) exempts from registration any "transactions by an issuer not involving any public offering."

In 1996 the Securities Act was amended by the National Securities Markets Improvement Act of 1996 ("NSMIA"). NSMIA was codified in 15 U.S.C. 77r that reads in pertinent part as follows:

> "(a) Scope of exemption. Except as otherwise provided in this section, no law, rule, regulation, or order, or other administrative action of any State or any political subdivision thereof . . .
>
> requiring, or with respect to registration or qualification of securities, or registration or qualification of securities transactions, shall directly or indirectly apply to a security that –
>
> (A) <u>is</u> a covered security....

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> (b) Covered securities. For purposes of this section, the following are covered securities: ....
>
> (4) Exemption in connection with certain exempt offerings. A security is a covered security with respect to a transaction that is exempt from registration under this subchapter pursuant to – ....
>
> (D) (SEC) rules or regulations issued under section 77d(2) of this title...." (Emphasis added.)

Title 15 U.S.C §77 does not state that a covered security is one that "might" or "may be" or "could be" exempt. It does not include in the definition a "covered security" one that does not meet the terms of the exemption. It expressly states that a security is "covered" only if it "is exempt". Similar language is found in Corporations Code §25102.1(d). In other words, the offering must comply with the terms of the exemption in order for the exemption to preempt action by a state regulatory agency. Plaintiffs have not alleged facts demonstrating their compliance with the exemption.

Regulation D provides exemptions, one of which is Rule 506, which lists requirements that must be met before an offering of a security is, under §77d(2), one "not involving any public offering". *17 C.F.R. §230.506.* Rule 506 incorporates limiting provisions of Rules 501 and 502 when it states at the outset that "to qualify for an exemption under this section, offers and sales must satisfy all the terms and conditions of sections 230.501 and 230.502." (Emphasis added.)

17 C.F.R. section 230.502(c) provides in pertinent part as follows:

> "Limitation on manner of offering. Except as provided in section 230.504(b)(1), neither the issuer nor any person acting on its behalf shall offer or sell the securities by any form of general solicitation or general advertising, including, but not limited to, the following:
>
> (1) Any advertisement, article, notice or other communication, published in any newspaper , magazine, or similar media broadcast over television or radio; and
> (2) Any seminar or meeting whose attendees have been invited by any general solicitation or general advertising...." (Emphasis added.)

It is commonly recognized in both state and federal securities law that the burden of proving an exemption or the affirmative defense of preemption is on the issuer. *California Corporations Code §25163; see Buist v Time Domain*, 2005 Ala. LEXIS 120; *Grubka v. Webaccess, Intl., Inc.* U.S. Dist LEXIS 44721 (2006); *SEC v Ralston Purina Co.* (1953) 346 U.S. 119, 126. Plaintiffs have not pled any facts to demonstrate compliance with Regulation D. Specifically, what triggered an

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investigation by the Department of Corporations was evidence showing that the Consolidated plaintiffs, as the issuers of the securities in the form of interests in joint ventures, and Guardian Capital acting in a sales capacity on their behalf, offered securities to citizens of California in the form of general solicitations by way of telephone calls and messages ("cold calls"), unsolicited mailings, advertising, invitations to luncheon/presentations and seminars attended by the general public who were not pre-determined to be accredited investors and had no pre-existing relationship with the plaintiff issuer. *See Plaintiffs' Exhibit 11, excerpt of transcript of the administrative hearing, page 129:11-24; p. 144:2-10.* These offerings violate the conditions of Regulation D Rule 506.

Plaintiffs have not stated any claim within the jurisdiction of this court because they have not pled facts that they fully complied with the requirements of Regulation D. If the offer is not in compliance with Regulation D, then there is no exemption pursuant to the federal rules, or under Corporations Code §25102.1, and the securities must be qualified as required by Corporations Code §25110. "A failure to comply with a requirement of Rule 506 'voids' the exemption, thereby eliminating the possibility of preemption." *Buist v Time Domain*, 2005 Ala. LEXIS 120.

In *Buist v. Time Domain, supra*, decided in July 2005, the supreme court of the State of Alabama was presented with very similar arguments that plaintiffs assert in this case. In the *Buist* case, the shareholder plaintiffs brought a civil action in state court for alleged violations of the Alabama Securities Act in the offer and sale of securities. The defendant corporations filed for a summary judgment arguing that the alleged state securities violations were preempted by federal law because the securities they sold were "covered securities" pursuant to Rule 506 of Regulation D and supported their motion with evidence that they had filed at least two Form D's with the Alabama Securities Commission. The defendant's motion was denied in part and the appeal ensued.

The Alabama supreme court on appeal upheld the denial of motion for summary judgment because the defendant corporations failed to show that the securities they offered were covered securities that were exempt under federal law. The court stated that each time the corporate defendant filed a Form D it "promised a future course of conduct consistent with the requirements for an exempt offering." *At 926 So.2d 297.* "In other words, the exempt status of the sale of securities

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that deviates from any of the material commitments made in its Form D filing is repealed retroactively." *Id., at p. 298.* With the exemption "repealed retroactively," any preemption is eliminated. The *Buist* court found that defendant Time Domain "submitted no evidence indicating that its sales of securities were actually made in conformity with Regulation D" and reversed a motion for summary judgment in its favor. *Ibid.*

The *Buist* court recognized that NSMIA amended the Securities Act "to obviate the necessity of registering certain securities with both state and federal governments by providing that <u>under certain conditions</u> state laws are preempted by the Securities Act." (Emphasis added.) The *Buist* case discusses the two cases cited by plaintiffs, *Temple vs. Gorman* 201 F. Supp 1238 (2002) and *Lillard v. Stockton,* 267 F. Supp.2d 1115 (N.D. Okla. 2003), the former decision written by a federal district court judge in Florida and the later written by a magistrate and adopted by a district court judge in Oklahoma. Plaintiffs rely on *Temple* in making their arguments here. As the *Buist* court notes, *Temple* arrived at its decision "ipse dixit"; the *Temple* court simply makes an unsupported assertion "without any accompanying analysis; *Lillard* in turn simply relies upon *Temple*." *Buist v Time Domain, supra*, at page 19. The *Buist* court dismisses these two district court cases, as this court should here, noting they did not fully analyze the facts and can only serve as "persuasive" and not controlling authority.

As the court in *Grubka v. Webaccess, Intl., Inc., supra,* U.S. Dist LEXIS 44721 (2006), observed:

> The *Temple* court read language into the statute that does not appear there. A security is covered if it "is exempt from registration . . . ."*15 U.S.C., §77r(b)(4)*. Nowhere does the statute indicate that a security may satisfy the definition if it is *sold pursuant to* a putative exemption. If congress had intended that an offeror's representation of exemption should suffice it could have said so, but did not. Such an intent seems unlikely, in any event; <u>that a defendant could avoid liability under a state law simply by claiming its alleged compliance with Regulation D is an unsavory proposition and would eviscerate the statute</u>." *At p. 28-29.* (Emphasis added.)

That is the case here. Plaintiffs assert the Commissioner had no authority to examine the offering, but allege no facts that they actually complied with the requirements of the exemption.

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4. THE COMMISSIONER HAD AUTHORITY TO ISSUE THE DESIST AND REFRAIN ORDER BECAUSE THE TRANSACTION WAS NOT EXEMPT UNDER CALIFORNIA LAW AND REGULATION D SO THERE IS NO BASIS FOR AN INJUNCTION.

California Corporations Code §25110 provides that "it is unlawful for any person to offer or sell in this state any security in an issuer transaction... unless such sale has been qualified under Section 25111, 25112 or 25113... or unless such security or transaction is exempted . . . ." (Emphasis added.) California exempts various transactions from the requirement of qualification or "registration" and plaintiffs base their assertion of exemption on Corporations Code §25102.1.

Corporations Code §25102.1 provides in pertinent part: "The following transactions are not subject to Sections 25110....(d) Any offer or sale of a security with respect to a transaction that is exempt from registration under the Securities Act of 1933 pursuant to Section 18(b)(4) of that act..." (Emphasis added.) This California statute was last amended in 1998 shortly after NSMIA was enacted, clearly to dovetail with the conditions of NSMIA. Section 25102.1 goes on to require the filing of a copy of the completed Form D filed with the SEC, a consent to service of process, and a filing fee, and there is no dispute that plaintiffs filed a "506 Notice" with California. However, §25102.1 expressly provides that it offers no protection unless the offer or sale is exempt under the federal Securities Act including Regulation D.

According to Corporations Code §25163: "In any proceeding under this law, the burden of proving an exemption or an exception from a definition is upon the person claiming it." Under federal law as well, plaintiffs have the burden of proving an exemption or the affirmative defense of preemption. *See Buist v Time Domain, supra*, at page 13-14, and *SEC v Ralston Purina Co.* (1953) 346 U.S. 119, 126. In order to claim the exemption and support the request for an injunction, plaintiffs must show their offering was exempt under either California law or under federal law. They have failed to show this.

The court in *Hamby v. Clearwater Consulting Concepts, LLP, et al.* 428 F. Supp. 2d 915; 2006 LEXIS 26886 (E.D. Ark. 2006), in declining to award summary judgment in favor of the issuer, stated:

> The defendants have the burden of proving an exemption from the registration requirements. *See Parker v. Broom, 820 F.2d 966, 968 (8th Cir. 1987).* Hamby

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> correctly points out that defendants have offered no affidavits or deposition testimony that the other investors were accredited investors under Regulation D. Other than the recitations in the Partnership Agreement tracking the requirements of Regulation D, the defendants have offered no evidence that their sales of the security at issue met the requirements for an exemption under *Rule 506*. The defendants have not shown that the sales were exempt as a matter of law. *Cf. Fed. R. Civ. P. 56(c)(e). (Emphasis added.)*

Similarly, the court in *AFA Private Equity Fund 1 v. Miresco Investment Services*, 2005 U.S. Dist. LEXIS 22071, denied defendant broker dealer's motion to dismiss, stating:

> Accordingly, SMH must present evidence showing that the securities at issue here are exempt from registration under the rules adopted by the SEC under § 4(2). Moreover, it is SMH's burden, as the party relying on the exemption, to establish that the exemption applies and that all conditions of the exemption have been satisfied. *See e.g., S.E.C. v. Ralston Purina Co.*, 346 U.S. 119, 126-27, 97 L. Ed. 1494, 73 S. Ct. 981 (1953). Likewise, under Michigan's Uniform Security Act, it is SMH's burden, as the person claiming it, to prove that an exemption applies. *Mich. Comp. Laws Ann. § 451.802(c)*. Accordingly, because the burden of proving the availability of an exemption from registration falls on SMH, Plaintiff has properly stated a claim for relief.

Plaintiffs have alleged no facts to demonstrate that they complied with the Regulation D requirements. As a result, there is no federal cause of action and injunctive relief is not supported by facts.

The Commissioner had authority to issue this Desist & Refrain Order under §25532(a) because the securities were offered without first being qualified and failed to meet the requirements of §25102.1:

> "If, in the opinion of the commissioner [of the Department of Corporations], (1) the sale of a security is subject to qualification under this law and it is being or has been offered or sold without first being qualified, the commissioner may order the issuer or offeror of that security to desist and refrain from the further offer or sale of the security until qualification has been made under this law or (2) the sale of a security is subject to the requirements of Section… 25102.1 and the security is being or has been offered or sold without first meeting the requirements of those sections, the commissioner may order the issuer or offeror of that security to desist and refrain from the further offer or sale of the security until those requirements have been met."

The Decision by the Administrative Law Judge found, based on evidence submitted, that plaintiffs violated the conditions of the Regulation D filing. As a result, plaintiffs offering did not fall within the exemption and the security was subject to qualification as set forth in Corporations Code §25110. There is no claim under federal law and no basis for this Court to issue an injunction.

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5. PLAINTIFF HAS FAILED TO STATE A CLAIM UNDER 42 USC §1983 SO THERE IS NO BASIS FOR AN INJUNCTION.

There is no relief for plaintiff in the federal court.

To establish a prima facie case under 42 U.S.C. § 1983, a plaintiff must demonstrate that (1) the action complained of occurred "under color of law," and (2) the action resulted in a deprivation of a constitutional right or a federal statutory right. *McDade v. West*, 223 F.3d 1135, 1139 (9th Cir. 2000) (citing *Parratt v. Taylor*, 451 U.S. 527, 535, 68 L. Ed. 2d 420, 101 S. Ct. 1908 (1981), overruled on other grounds by *Daniels v. Williams*, 474 U.S. 327, 330-31, 88 L. Ed. 2d 662, 106 S. Ct. 662 (1986)). *Azer v. Connell,* 306 F.3d 930, 935 (9th Cir. 2002).

In this case, plaintiffs completely fail to articulate any facts which "result in a deprivation of a constitutional right or a federal statutory right." *Ibid.*

Under NSMIA states are precluded from "imposing laws, rules, regulations, orders, or other administrative actions that require issuers of "covered securities" to register or qualify securities transactions." The Commissioner has not, however, imposed any laws, rules, regulations or orders, except as a result of plaintiffs' failure to follow the specifications of Regulation D by offering the investments by way of a general solicitation. The counterpart exemption in California, §25102.1, applies only so long as the offeror is in compliance with Regulation D. That section permits a "notice filing" of a Regulation D exemption, but applies only if the security actually "is exempt" from registration pursuant to Regulation D. Logically, if the offering is not exempt, §25102.1(d) does not apply and §25110 requires qualification in the state. If it were otherwise, an offeror could violate Regulation D, which in turn would constitute a violation of the state qualification/registration statutes, but be free from scrutiny if the SEC failed to initiate an investigation, effectively creating an unregulated market of fraudulent offerings. *See Grubka v. Webaccess International, Inc.*, 2006 U.S. Dist. LEXIS 44721, at 28.

Plaintiffs' argument that this is not a security was rejected by the Administrative Law Judge. The factual finding at the administrative level was that plaintiffs violated the conditions of Regulation D by offering the investment in a general solicitation to unqualified investors. The Commissioner's action was justified.

Without full compliance with the asserted exemption, plaintiffs cannot claim that they were offering a "covered security" for purposes of the federal statute, nor can they claim the exemption

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from qualification/registration and its preemptive effect under either federal or state law. Plaintiffs have not alleged compliance with the requirements of Regulation D and as a result, plaintiffs have not stated a claim under federal law and the request for injunctive relief based on Regulation D should be denied.

D. CONCLUSION.

Plaintiffs failed to allege any facts that confirm they complied with all the requirements of Regulation D and demonstrate that they could avail themselves of that exemption/preemption and Corporations Code §25102.1(d). Plaintiffs' action here directly contradicts the findings of fact and conclusions of law obtained in the administrative process; a process initiated by plaintiffs. Under *Gayle v. County of Marin* and *Miller v. County of Santa Cruz*, the administrative process met the conditions that would support the preclusive effect of "state administrative adjudications of legal as well as factual issues" and plaintiffs should be barred from relitigating these issues here.

The Department of Corporations, through its Commissioner, is and was authorized by state law to investigate and prosecute violations of the Corporate Securities Law. Having determined plaintiffs were not in compliance with the conditions of the Regulation D exemption, the Commissioner proceeded as required by Corporations Code §25531 and §25532, by investigating and issuing a D&R Order. Plaintiffs have not demonstrated either irreparable harm or any other compelling need for an injunction halting the effect of the administrative order.

The Commissioner respectfully requests that the Court deny plaintiffs' motion for injunctive relief.

DATED: August 4, 2006

Respectfully submitted,

PRESTON DuFAUCHARD
California Corporations Commissioner

By /s/ James K. Openshaw
JAMES K. OPENSHAW
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