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August 17, 2012

**E-FILED VIA ECF SYSTEM**

Hon. Edward J. Davila  
United States District Judge  
San Jose Courthouse  
Courtroom 4 – 5<sup>th</sup> Floor  
280 South First Street  
San Jose, CA 95113

Re: SEC v. Small Business Capital Corp. et al, Case No. 5:12-cv-03237-EJD (N.D. Cal.)

Dear Judge Davila:

On behalf of Defendant Mark Feathers, we respectfully submit this reply to the SEC's and Receiver's opposition to the limited use of our client's receivership assets to pay for defense costs.

**INTRODUCTION**

The SEC's opposition generally reiterates allegations in its complaint instead of addressing Mr. Feathers's substantive evidence.

- The SEC ignores that the operating agreements for IPF and SPF, the funds managed by Mr. Feathers's management company, contain express indemnity provisions for the immediate payment of his defense costs for any claim, including fraud, before a final determination of his liability (or lack thereof). Under well-established California precedent, this indemnity obligates the estate to cover Mr. Feathers's defense pending a final determination in the case.
- The SEC repeatedly argues that SB Capital's assets are "other people's money," but concedes that Mr. Feathers has an independently documented equity stake in the company of at least \$550,000 – i.e., well in excess of Mr. Feathers's requested legal budget. The government then attempts to cast doubt on this stake without offering any evidence, much less admissible documentation, to refute our client's *prima facie* showing. Likewise, the Receiver's submission avoids the issue altogether by stating

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he does not yet know the amount of Mr. Feathers's equity interest because his accounting is not complete – even though all of this information has been within the SEC's and the Receiver's possession since before this action began.

- The SEC fails to address Mr. Feathers's precedent permitting a defendant the use of frozen assets for a defense.
- The SEC does not dispute the reasonableness of our proposed, discounted budget for Mr. Feathers's defense, which is well below the Receiver's own estimated costs over a shorter period of time.

Fundamentally, the SEC and Receiver ignore the equities in this case. Mr. Feathers was cooperating with the government for over seven months when the SEC unilaterally decided to seek TRO relief and the appointment of a receiver over the Funds Mr. Feathers managed for years. The SEC then attempts to stand the law and the Funds' indemnity agreements on their head by asking the Court to presume that Mr. Feathers is guilty until proven innocent – without counsel. The duty to indemnify arises immediately, and a party cannot avoid this duty by simply assuming that an exception applies. *See, e.g., Crawford v. Weather Shield Mfg. Inc.*, 44 Cal. 4th 541, 558 (2008). There is no dispute that for several years, Mr. Feathers invested sweat equity and his own money into his business. The Operating Agreements provide for indemnity, and there may be insurance coverage as well. Under basic principles of fairness, the Court should permit Mr. Feathers the opportunity to have the assistance of counsel by granting his request for limited, discounted attorney's fees. These fees are reasonable, will be supervised by the Court on an on-going basis, and are necessary to ensure a fair and efficient proceeding.

## ARGUMENT

### **I. THE FUNDS' OPERATING AGREEMENTS PROVIDE FOR INDEMNITY**

The SEC largely ignores that the relevant Operating Agreements, which are governed by California law, contain an express indemnity to Mr. Feathers from the Funds for all civil proceedings against him.<sup>1</sup> The relevant indemnity language states:

The Manager and its agents or Affiliates and the shareholders, officers, directors, employees and agents of such agents or Affiliates and the employees and agents of the Company shall be entitled to be indemnified and held harmless by the Company, at the expense of the Company, against any loss, expense, claim or liability (***including reasonable attorneys' fees, which shall be paid as incurred***) resulting from the assertion of any claim or legal proceeding relating to the performance or nonperformance of any act concerning the activities of the Company, including claims or legal proceedings brought by a third

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<sup>1</sup> Both the SEC and the Receiver also ignore that there may be insurance coverage.

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party of by Members, on their own behalf or as a Company derivative suit, so long as the party to be indemnified determined in good faith that such course was in the best interest of the Company and did not constitute fraud, bad faith or willful misconduct; provided, that any such indemnity shall be paid solely from the assets of the Company.

(Dkt No. 54 at 2, Receiver's Letter (emphasis added).)

The Receiver, in an overt misreading of this language and without citation to any legal authority, maintains that the conduct-based exemption for fraud somehow bars indemnification before those allegations have been established. (*Id.*) This position is contrary to California law and the intent of indemnity to provide a defense of any and all claims. *See* Cal. Civ. Code 2778 (indemnitor is bound to defend actions brought against the indemnitee); *DeWitt v. Western Pacific R. Co.*, 719 F.2d 1448, 1451-52 (9th Cir. 1983) (indemnification is required for all claims contemplated by the indemnity contract).

Moreover, the indemnity agreement here goes far beyond similar clauses and actually affirmatively requires the payment of attorney's fees "*as incurred.*" Accordingly, under the very contract at issue, any conduct-based exception to this indemnity could only arise after findings and a final determination that Mr. Feathers committed fraud – issues that are far from being decided by the Court or a jury.

The Receiver also expresses the view, again without any case precedent, that only the "innocent" are entitled to indemnification. (Dkt No. 54 at 2.) This position is contrary to the indemnity and makes no sense. It would render Mr. Feathers's right under the Operating Agreements a complete nullity. Under the Receiver's view, the mere accusation of fraud, whether unfounded or not, would trigger a brightline exception and automatically exclude coverage for the indemnified party. Thankfully, indemnitees are not subject to such pressure. Under well-established California law, the duty to defend arises immediately upon tender, before the litigation to be defended has determined whether indemnity is actually owed, and regardless of the eventual outcome of that litigation and continues until such time as it has been determined by the trier of fact that a conduct-based exception applies. *See Crawford v. Weather Shield Mfg. Inc.*, 44 Cal. 4th 541, 558 (2008) (the duty to defend an indemnitee against all claims embraced by the indemnity arises as soon as such claims are made and cannot depend on the outcome of the litigation to be defended to determine whether there is an obligation to pay indemnity.)

In passing, the SEC suggests that the Court can ignore the indemnity provision of the Operating Agreements and not release fees for Mr. Feathers's defense, relying on *SEC v. Onyx Capital Advisers, LLC*, Case No. 10-cv-11633, 2011 WL 4528216 (E.D. Mich. September 29, 2011). (Dkt. No. 51 SEC's Letter at 10.) The SEC misreads its own case. In *Onyx*, the indemnity agreement did not provide for the payment of attorney's fees *as they are incurred* as is the case here. *Id.* at \*3. Additionally, the contract in *Onyx* was governed by Delaware law which provides that if indemnification is conditioned on the conduct of the indemnitee, then indemnification cannot be determined until after the merits of the underlying dispute are resolved. *Id.* at \*4. As noted above, the law in California which governs the Operating

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Agreements is different, and requires an indemnifying party to pay for defense costs until a final determination on the merits.

Last, the Receiver takes issue with the Court's statement at the July 27, 2012 hearing that the Receiver and his counsel are being paid from the receivership estate. The Receiver deems the Court's comparison inappropriate because it contends that Mr. Feathers's defense will not benefit investors. This attempted distinction is misguided. First, it presumes that Mr. Feathers is guilty and is a detriment to the Funds – rather than that Mr. Feathers will be vindicated and return to managing them. Second, the anticipated fees of Mr. Feathers's defense are offered at a substantial discount and will undoubtedly cost the receivership estate less than it would spend defending unnecessary litigation related to the refusal to indemnify Mr. Feathers. Third, because Mr. Feathers is contractually entitled to indemnity, the offer to discount attorney's saves the receivership estate the 20% it would otherwise have to pay Mr. Feathers's counsel were he inclined to strictly enforce the Funds' contractual obligation to defend him. Fourth, the Receiver overlooks the added costs associated with litigation involving *pro se* defendants in SEC enforcement actions, including the costs of responding to overbroad or otherwise duplicative discovery, unnecessary motion practice, and the myriad of other ways in which *pro se* defendants can unintentionally interrupt the smooth functioning of a receivership estate. Finally, the Receiver ignores the extensive experience Mr. Feathers's counsel in litigating SEC receivership actions. The undersigned counsel has worked closely with the Receiver's counsel on cases between 2007 and 2011, and there is no real dispute that the undersigned counsel will manage this case appropriately and efficiently.

## **II. MR. FEATHERS'S ASSERTED EQUITY STAKE IN THE FUNDS IS UNREBUTTED**

The heart of the opposition is the SEC's inaccurate and unsupported claim that Mr. Feathers is seeking to use "other people's money" for his defense. To bolster its mischaracterization, the SEC describes Mr. Feathers's capital contributions as "vague," while referencing the accounting ledger that Mr. Feathers's counsel provided to it. (Fickes Decl., Ex. 3.) However, this ledger was prepared around May 2012, before this litigation arose, by SB Capital's Controller, Mae Saechao. It reflects journal entries for Mr. Feathers's purchases of SB Capital stock and SB Capital's corporate repurchases from him. The ledger also shows that, as of November 30, 2010, Mr. Feathers had contributed a net of \$688,000 to SB Capital.

Although Mr. Feathers does not currently have the access to SB Capital's financial records that the SEC and Receiver have, he estimates that he borrowed approximately \$100,000 from SB Capital which does not appear to be reflected in the Controller's ledger, rendering his net capital contribution to be approximately \$550,000. Additionally, Mr. Feathers has at least an 80% equity interest in SB Capital.

Neither the SEC nor the Receiver provide any evidence to refute that Mr. Feathers made capital contributions to SB Capital. The SEC simply labels the evidence of Mr. Feathers's equity as vague without offering any evidence to refute it. (Dkt. No. 51 at 5.) The Receiver acknowledges that the Court did not solicit his views, yet opines that Mr. Feathers has not

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offered documents to support his equity contribution. (Dkt. No. 54 at 1.) To the contrary, Mr. Feathers provided the SEC with the independently-authored accounting ledger. (Fickes Decl., Ex. 3.) Moreover, Mr. Feathers believes that the ledger, together with any supporting documentation, such as copies of checks, are in the offices of SB Capital.

The Receiver also opines that Mr. Feathers's salary was somehow excessive without offering any evidence about what market salaries are for individuals with Mr. Feathers's background and experience. (Dkt. No. 54 at 1.) As this case proceeds, we anticipate showing that his compensation was well-below market. Finally, the Receiver acknowledges that his accounting is not yet complete. Moreover, Mr. Feathers disputes many of the Receiver's preliminary conclusions about the state of the Funds. In any event, Mr. Feathers's evidence regarding his equity stake in SB Capital remains unrebutted.

### **III. THE SEC DOES NOT ADDRESS SUBSTANTIAL PRECEDENT PERMITTING THE USE OF FROZEN ASSETS TO PAY FOR ATTORNEY'S FEES AND CITES INAPPOSITE CASES DENYING ATTORNEY'S FEES**

Rather than address the merits of the cases cited by Mr. Feathers in support of his request for fees, the SEC creates a straw-man argument falsely asserting that Mr. Feathers claims a constitutional right to counsel. (Dkt. No. 51 at 6.) The SEC then cites a long line of cases standing for the proposition that the Sixth Amendment does not guarantee a right to counsel in civil proceedings. (*Id.*) This is not in dispute. Rather, Mr. Feathers maintains there is a substantial body of authority permitting the use of frozen assets to pay for attorney's fees in civil enforcement proceedings. (*See, e.g.*, Mr. Feathers's Opening Letter Brief at 4-6 (Dkt. No. 48) (collecting authorities).)

Next, the SEC argues that the authority cited by Mr. Feathers does not stand for the proposition that he may use "other people's money" to secure his defense. (Dkt. No. 51 at 9.) As noted above, the SEC's assertion that Mr. Feathers is looking to use other people's money is false in light of his own equity interest and in light of the indemnity provisions of the Funds.

The SEC attempts to distinguish *Fed. Sav. & Loan Ins. Corp. v. Dixon*, 835 F. 2d 554 (5th Cir. 1987) (cited in Opening Letter Brief at 5-6 (Dkt. No. 48)), by claiming the Court did not sanction the use of assets of a separate entity. (Dkt. No. 51 at 9.) This is inaccurate. In *Dixon*, on appeal, the FSLIC argued "more stringently that the defendants *should not be allowed to use the savings institution's assets to defend themselves in an action brought against them for ruining the savings and loan.*" *Id.* at 565. (emphasis added). The Court wrote:

As compelling as that argument is, and despite considerable evidence that its factual premise is correct, this suit was brought to establish defendants' wrongdoing; the court cannot assume the wrongdoing before judgment in order to remove defendants' ability to defend themselves. The basis of your adversary system is threatened when one party gains control of the other party's defense as appears to have happened here. Thus, we conclude that

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some kind of allowance must be made to permit each defendant to pay reasonable attorneys' fees..."

*Id.* (internal citations omitted).

The other authorities cited by the SEC to deny Mr. Feathers attorney's fees are inapposite. For example, in *SEC v. Quinn*, 997 F.2d 287, Quinn was imprisoned for his role in an international securities fraud. *Id.* at 288. While Quinn was imprisoned, the District Court indicated a willingness to release some funds for attorney's fees and on occasion did so, and stopped only after Quinn refused to catalogue his assets as ordered and used released funds for services not related to his legal defense. *Id.* at 289. Mr. Feathers had not been convicted nor imprisoned for his role in any fraud. Rather, he stands accused. Additionally, Mr. Feathers has complied with the Court's Order that he provide a catalogue of his assets as ordered by the Court, and the SEC does not contend otherwise.

The SEC also relies on *FTC v. World Wide Factors, Ltd.*, 882 F.2d 334 (9th Cir. 1989) for the proposition that Court's "routinely" deny requests for attorney's fees in civil enforcement actions. In *World Wide Factors*, however, the defendant pleaded guilty to a criminal indictment for mail and wire fraud and agreed to liquidate his business for pay restitution to his victims. *Id.* at 346. Although the Court of Appeal recognized that Courts have denied the use of frozen assets to pay attorney's fees, the Court of Appeal found the trial Court's limitation on the use of frozen assets to pay for fees to the rate paid for criminal defense counsel pursuant to the Criminal Justice Act "arbitrary and an abuse of discretion." *Id.* at 348. The Court of appeal remanded the case with instructions to determine whether any hourly rate limitation was necessary in light of the district court's prior order permitting the withdrawal of reasonable sums for attorney's fees. *Id.* Thus, *World Wide Factors* actually stands for the proposition that Mr. Feathers is entitled to reasonable attorney's fees.

The SEC's reliance on *SEC v. Cherif*, 933 F.2d 403 (7th Cir. 2001) is similarly misplaced. In *Cherif*, the defendant was initially permitted to use frozen assets to pay for attorney's fees. *Id.* at 416. He objected to the Court's refusal to modify the injunction to permit him to use additional frozen assets for attorney's fees after he refused to comply with the Court's order to provide an accounting. *Id.* The Court of Appeal held it was not an abuse of discretion to refuse further money for attorney's fees where the defendants refused to comply with the required accounting. *Id.* at 17. Unlike the situation in *Cherif*, Mr. Feathers complied with the Court's order to provide an accounting.

#### **IV. THE SEC DOES NOT DISPUTE THE REASONABLENESS OF THE PROPOSED DEFENSE BUDGET**

Last, but not least, the SEC does not dispute the reasonableness of the proposed defense budget. Rather, the SEC claims that Mr. Feathers's counsel seeks a \$375,000 retainer for work yet to be performed. This is false. Our budget reflects Mr. Feathers's anticipated, heavily discounted, fees and costs in the case. Our proposal is to submit fee applications on a monthly or quarterly basis for *in camera* review by the Court. Thus, counsel will only receive fees for work

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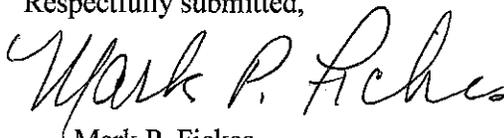
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actually performed and approved by the Court. Additionally, in our practice, not only is the budget reasonable, it is well below what other similarly-experienced counsel might charge for such work. Finally, it is worth noting that our budget is less than the budget proposed by the Receiver for his fees and those of his attorneys through the close of 2012. (*See* Receiver's Second Interim Report and Petition for Instructions at 12-13 (Dkt. No. 53).)

**CONCLUSION**

Numerous federal courts have upheld the right of individuals subject to government enforcement actions to retain counsel. This right is especially important where, as here, Mr. Feathers has meritorious defenses that he will never be able to assert unless he has proper representation. Mr. Feathers and his family have been deprived of their funds, jobs, and careers, and have no way to pay their mortgages on agreed-upon terms with their lenders. This proceeding will further destroy their lives, unless Mr. Feathers is afforded the opportunity to contest the SEC's serious allegations.

Respectfully submitted,

A handwritten signature in cursive script that reads "Mark P. Fickes". The signature is written in black ink and is positioned above the printed name.

Mark P. Fickes