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UNITED STATES DISTRICT COURT

NORTHERN DISTRICT OF CALIFORNIA

SAN JOSE DIVISION

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

vs.

SMALL BUSINESS CAPITAL CORP.; MARK FEATHERS; INVESTORS PRIME FUND, LLC; and SBC PORTFOLIO FUND, LLC,

Defendants.

Case No. CV12-03237

REPLY TO RESPONSES TO MOTION FOR APPROVAL OF DISTRIBUTION PLAN AND AUTHORIZATION TO MAKE INTERIM DISTRIBUTIONS

Date: January 31, 2014
Time: 9:00 a.m.
Ctrm: 4 - 5th Floor
Judge: Hon. Edward J. Davila

Thomas A. Seaman ("Receiver"), the Court-appointed permanent receiver for Small Business Capital Corp. ("SB Capital"), Investors Prime Fund, LLC ("IPF"), SBC Portfolio Fund, LLC ("SPF"), and their subsidiaries and affiliates ("Receivership Entities"), submits this reply in support of his Motion for Approval of Distribution Plan and Authorization to Make Interim Distributions ("Distribution Plan Motion"). The Receiver responds to the oppositions to the Distribution Plan Motion as follows:

I. SMALL BUSINESS ADMINISTRATION

The U.S. Small Business Administration ("SBA") opposes the Distribution Plan Motion on the grounds that none of the proposed $19 million interim distribution will go to the SBA. The SBA submitted a claim for $24,181,665.40, all but $34,269 of which is contingent based on the SBA's contentions that certain SBA loans originated by the Receivership Entities did not conform to loan program rules. The SBA argues its $34,269 liquidated claim should be paid in full[1] and that some assurance there will be adequate funds available to resolve its contingent claim should be provided. Declaration of Thomas Seaman filed herewith ("Seaman Declaration"), ¶ 2.

The alleged "irregularities" with the loans on which the SBA claim is based are non-monetary in nature. Rather, the SBA contends certain loans do not comply with federal regulations, including, for example, that certain 504 loans which the borrowers used to purchase or renovate hotel properties violate federal regulations because the loan proceeds were used to finance the acquisition of hotels with swimming pools. The SBA claim is not based on the performance of the loans or an assessment of risk or exposure to losses. Seaman Declaration, ¶ 3.

The Receiver's discussions with the SBA are ongoing. It is likely the SBA's contingent claim will be satisfied through a sale of 7(a) and 504 loan portfolios. It is anticipated the buyer of each portfolio will assume any and all liability to the SBA arising from such portfolio as part of the purchase. In that event, the amount of the SBA claim will not need to be addressed by the Receiver or the Court. Accordingly, in connection with the Claims Motion, the Receiver has proposed that

[1] The $34,269 relates to an audit of outstanding SBA loans conducted by the SBA which it claims the contractual right to recover from the Receivership Entities. The Receiver does not dispute this portion of the claim, provided the SBA produces the audit report to the Receiver, which it has indicated it will.

the Court's determination of the SBA claim be deferred until a sale of each loan portfolio is proposed. Seaman Declaration, ¶ 4.

The Receiver believes the proposed cash reserve (approximately $1.6 million), the monthly interest and servicing income (approximately $200,000 per month), the loan portfolios (approximately $15.6 million outstanding), and the SBA lending license, provide an adequate reserve of assets for the SBA's claim. The loan portfolios overall are performing well, and the SBA loans that have had problems are adequately collateralized. The Receiver estimates the SBA's actual exposure to loan losses is less than $1 million. Seaman Declaration, ¶ 5.

The Receiver and the SBA continue to discuss the reserve. The Receiver hopes a reserve will be agreed upon shortly. Either way, the Receiver will report the status of his discussions with the SBA at least 14 days prior to the January 31, 2014 hearing. Seaman Declaration, ¶ 6.

The SBA asserts distribution is premature "before the Receiver has made any attempt to sell the SBA loan portfolio . . ." Opposition, p. 4. The Receiver disagrees that distribution is premature. Investors, many of whom invested a substantial portion of their savings with the Receivership Entities, have been waiting more than 18 months to receive a distribution. In light of this financial hardship, the Court agreed to advance the hearing date on the Distribution Plan Motion and related Claims Motion by almost three months. Seaman Declaration, ¶ 7.

It is also incorrect to say the Receiver has not made any attempt to sell the SBA loan portfolio. The Receiver has been working with the SBA over the last six months to agree on procedures for the sale of the loan portfolios and the lending license. Much of this time has been spent waiting for the SBA to provide proposed procedures. As soon as an agreement is reached, the Receiver will seek Court approval of the sale procedures. Seaman Declaration, ¶ 8.

II. DR. STEPHAN HENGSTLER

Dr. Hengstler, an investor, opposes the Distribution Plan Motion and requests the Receiver provide a comparison of distributions under the proposed rising tide method and the net loss method. How much will be available to distribute after the sale of remaining assets is unknown, but looking only at the initial distribution and assuming $19,000,000 is distributed, each investor would receive 46.64% of their net loss amount under the net loss method. Each claimant's net loss

amount is reflected on Exhibit A to the Declaration of Thomas Seaman filed with the Claims Motion. Docket No. 626-1. By comparison, after an initial distribution of $19 million under the rising tide method, all claimants will receive 52.387% of their contributions, including pre-receivership and post-receivership distributions.

Dr. Hengstler is one of a minority of claimants (63 of 374) who will receive less under the rising tide method than the net loss method. Again, assuming an initial distribution of $19 million, he would receive $8,676.36 under rising tide and $44,041.36 under net loss. This is because Dr. Hengstler received more than $85,000 in distributions prior to the receivership, or approximately 48% of his contributions. The vast majority of investors received a much smaller percentage of their contributions, if they received anything at all. Naturally, Dr. Hengstler prefers the distribution method under which he receives more.

Any method of distributing receivership assets necessarily favors some claimants over others. The goal is to distribute assets as fairly and equitably as possible. As discussed in the Distribution Plan Motion, where a relatively small number of claimants receive less under rising tide than under net loss, courts have found rising tide to be the preferred method. *See SEC v. Huber*, 702 F.3d 903 (7th Cir. 2012); *United States v. Cabe*, 311 F. Supp. 2d 501, 509 (D.S.C. 2003); *CFTC v. Wilson*, 2013 WL 3776902, *7 (S.D. Cal. July 17, 2013).

Here, as discussed in the Distribution Plan Motion, only about 5% of claimants receive less under rising tide than net loss, meaning about 95% of claimants recover a greater percentage of their losses. The 95% of claimants are those with more severe losses, whereas the 5% are those who recovered a significant portion of their contributions prior to the receivership. Accordingly, the Receiver believes rising tide is the more fair and equitable distribution method.

III. J. ROBERT GILROY

J. Robert Gilroy, President of First West Capital Corporation ("FWCC"), filed a letter addressed to counsel for the Securities and Exchange Commission. Docket No. 644. FWCC is an investor in SPF. The letter objects to the Distribution Plan and argues the assets of SPF should not be pooled with the assets of other Receivership Entities. Mr. Gilroy states the Receiver and his counsel told him in October 2012 the assets of the Receivership Entities would likely be pooled.

Mr. Gilroy ignores the extensive transfers of cash, loans, and investor accounts between the Receivership Entities discussed in the Distribution Plan Motion and the Receiver's Forensic Accounting Report. As noted therein, SPF was the net beneficiary of inter-fund transfers to the tune of more than $9.9 million. It is not surprising, therefore, that FWCC, an SPF investor, would prefer not to have SPF's assets pooled with the assets of the other Receivership Entities. Segregating SPF's assets would only exacerbate the fraud, however, as investors in IPF and SCMF would suffer greater losses as a result of the improper inter-fund transfers benefitting SPF. It is more fair and equitable to have all claimants recover from one pool of assets.

The fact the Receiver and his counsel anticipated pooling would be the most fair and equitable solution back in October 2012 has no bearing on the issue. The Receiver and his counsel have experience in Securities and Exchange Commission ("Commission") enforcement actions and have seen fraudulent schemes similar to the one operated by defendants. The Receiver and counsel's guess as to what a distribution plan might look like was simply based on experience. In the end, the Receiver's completed accounting and the Court's findings as to the Commission's underlying claims served to frame the proposed plan terms.

Mr. Gilroy complains his proposal to liquidate the loan portfolios in September 2012 was not accepted. Mr. Gilroy's proposal completely ignored several critical factors, including that Mr. Feathers was contesting the Commission's case and the loan portfolios and lending license are subject to SBA regulations and contracts, which impose certain barriers to liquidation. Among other things, Mr. Gilroy appears to simply waive off the SBA's $24 million claim, something the SBA will strongly oppose. The Receiver and his counsel communicated these flaws in the proposal to Mr. Gilroy.

Finally, Mr. Gilroy's "report card" completely misrepresents the value of the receivership estate since the Receiver's appointment. The $34.124 million amount Mr. Gilroy uses as his starting value was a preliminary estimate provided less than two weeks after the Receiver was appointed. It includes $750,000 for the SBA lending license, $327,000 for the California Business Bank ("CBB") stock, as well as amounts for the Natoma, Sweet Fingers, and Whiskey Junction loans. Mr. Gilroy notes that the Receiver's most recent report (filed on October 18, 2013) shows

$17.492 million in outstanding loans and $15.988 million in cash. These amounts do not include any values for Real Estate Owned, the SBA lending license, or the CBB stock. Therefore, comparing them to the $34.124 million preliminary estimate is comparing apples to oranges. Mr. Gilroy then subtracts the unpaid professional fees[2] to arrive at $31.970 million, which he concludes is a $4.3 million loss in value. Notwithstanding the improper comparison, Mr. Gilroy's arithmetic is incorrect; the difference between $34.124 million and $31.970 million is $2.154 million.

Furthermore, as of now, the receivership estate has approximately $20.982 million in cash and $13.304 million in loans (after deducting the loan loss reserve), for a total of $34.287 million. Therefore, without including any value for the SBA lending license or the CBB stock, the current value is approximately $163,000 greater than the preliminary $34.124 million estimate. The Receiver has more than doubled the cash in the receivership estate since his appointment. The only reason the value of outstanding loans has gone down is loans have been paid off in full, with the exception of The Four Brothers Inns, for which the Court approved a discounted payoff. Docket Nos. 419 and 456.

IV. CONCLUSION

Based on the foregoing, the Receiver requests an order (a) approving the Distribution Plan, (b) authorizing the Receiver to make an initial round of interim distributions totaling $19 million, (c) authorizing the Receiver to make subsequent interim distributions in his discretion (with notice to and approval of the Commission), and (d) automatically disallowing any and all claims submitted to the Receiver after September 25, 2013.

Dated: December 10, 2013

ALLEN MATKINS LECK GAMBLE MALLORY & NATSIS LLP

By: /s/ Ted Fates
TED FATES
Attorneys for Receiver Thomas A. Seaman

[2] Mr. Gilroy complains the fees and costs of the Receiver and his counsel, including unpaid fees, are over $2 million. As the Receiver has previously explained, the costs of the Receiver and his counsel for managing the Receivership Entities and performing tasks specific to the receivership (including the forensic accounting) are vastly less than the operating expenses the Receivership Entities were paying prior to the Receiver's appointment. Mr. Feathers would have paid himself and his employees approximately $4.64 million over the same 18-month period.