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SUPERIOR COURT OF THE STATE OF CALIFORNIA

FOR THE COUNTY OF SACRAMENTO

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| THE PEOPLE OF THE STATE OF CALIFORNIA, by and through the COMMISSIONER OF CORPORATIONS,<br><br>Plaintiff,<br><br>v.<br><br>HAPJACK MARKETING, INC.; INNOVATIVE BUSINESS SOLUTIONS, LLC; HOTEL CONNECT, LLC; WORLD CASH NETWORK, LLC; BILLY RAY SMITH; CLAUDE D. SMITH; DAVID D. FARRELL; AND DOES 1 through 100,<br><br>Defendants. | Case No. 00AS00776<br><br>STATEMENT OF DECISION (CRC 232)<br><br>[Proposed]<br><br>Trial Date: November 2, 2001 |

The above-referenced matter came on regularly for trial in Department 15 on November 2, 2001, before the Honorable Judy Hersher. Karen L. Patterson, Mark J. Breckler, James K. Openshaw and Daniel P. O'Donnell appeared for the plaintiff, the People of the State of California by and through the Commissioner of Corporations ("the Commissioner"). There was no appearance by or on behalf of the non-settling defendants. The Court therefore confirmed that notice of the trial had been served in accordance with Code of Civil Procedure § 594 and

proceeded to receive evidence on November 2 and 5, 2001, against those defendants, including Claude D. Smith, Billy Ray Smith, David D. Farrell, Hotel Connect, LLC, World Cash Network, LLC, Innovative Business Systems, LLC and Hapjack Marketing, Inc. The seven defendants are referred to collectively hereafter as "defendants."[1]

Evidence was admitted in the form of offers of proof on behalf of proposed witnesses who were present in the courtroom, and who confirmed and/or amended the offers for accuracy. Witnesses whose testimony was admitted in this fashion included Raymond Miller, Leonard Mastrandrea, Susan Chase, Eugene Chase, Linda Brunetti, Harold P. Coffin, Gary Appelblatt, Edward Prentice and Jeff Robertson. Additional evidence was admitted in the form of deposition testimony of Billy Ray Smith, Brian T. Griggs and Mark L. Ehrlich, and sworn examination testimony of Mike Goodman and Robert V. Lilly. Declaration testimony was admitted from Mildred N. Gray, Vera Keller, Willian D. Zalabak and Carolyn Olson. Documentary exhibits were also received into evidence.

No objections were asserted to either the form or substance of the testimony of any of the witnesses, or to any of the documentary exhibits.

Having heard, read, and considered the evidence, the Court hereby makes the following findings of fact and reaches the following conclusions of law:

## FINDINGS OF FACT

1. From approximately late 1996 until late 1999, the defendants engaged, collectively and individually, in the offer and sale of approximately 528 9-month promissory notes, in minimum principal amounts of $25,000, issued by defendants Innovative Business Solutions, LLC (IBS), Hotel Connect, LLC (HC), and World Cash Network, LLC (WCN). The notes were sold throughout the United States, including California and Sacramento County, and were supposed to be used to raise capital to fund business operations of the three issuing companies.

[1] Four additional defendants, Gary L. Appelblatt, Harold P. Coffin, Mark L. Ehrlich and Brian T. Griggs, reached settlements with the Commissioner prior to trial. The Commissioner received reports prior to trial that defendant Billy Ray Smith died in August of 2001 but has received no formal notice of his death. The Commissioner elected to proceed to seek a judgment against him. (See 1 Weil & Brown, Cal. Practice Guide: Civil Procedure Before Trial (The Rutter Group) ¶ 2:503, page 2-85 rev. #1 2000.)

2. Defendant IBS was formed during mid-1996, purportedly to sell, install, operate and service automated teller machines, debit card equipment and credit card terminals. Ex. 4, page 9 (this page is numbered "3" at its bottom center). IBS made an initial offering of $5 million in 9-month promissory notes on December 1, 1996. Between January 14, 1997 and July 13, 1999, IBS 9-month promissory notes were sold in a total amount of approximately $3.28 million. Testimony of Jeff Robertson (Robertson testimony), Ex. 99. Defendant Billy Ray Smith was one of the initial owners of IBS but later sold his entire interest in the company to his brother Claude for one dollar ($1) because "Claude Smith wanted to take it over." Deposition testimony of Billy Ray Smith (BR Smith Deposition, page 125, line 3).

3. Defendant Hotel Connect, LLC ("Hotel Connect") was formed in March of 1997, purportedly to purchase, install and maintain telephone equipment in hotel rooms. Hotel Connect made an initial offering of $5 million in 9-month promissory notes in March of 1997; in December of 1997 the offering was increased to $10 million. Between May 14, 1997 and August 23, 1999, Hotel Connect 9-month promissory notes were sold in a total amount of approximately $12.25 million. Robertson testimony; Ex. 99. Claude Smith was the CEO of Hotel Connect and provided overall management and directed its operations. Deposition testimony of Mark L. Ehrlich ("Ehrlich testimony), pages 30-31. Billy Ray Smith was an original owner of 26% of Hotel Connect. BR Smith Deposition.

4. World Cash Network, LLC ("World Cash") was formed in September of 1997, purportedly to install, operate and service automated teller machines, debit credit card equipment and terminals, credit card equipment and terminals and scrip machines and their associated equipment. Ex. 6, page 13 (this page is numbered "6" at its bottom center). World Cash made an initial offering of $5 million in 9-month promissory notes in September of 1997. Between November 12, 1997 and September 16, 1999, World Cash 9-month promissory notes were sold in a total amount of approximately $6.10 million. Robertson testimony; Ex. 99. Mark Ehrlich was hired by Claude Smith to serve as the president of World Cash. Ehrlich testimony, page 61.

5. The 9-month promissory notes issued by IBS, Hotel Connect and World Cash were marketed by and through defendant Hapjack Marketing, Inc. (Hapjack), which served as the

"master agent" of the enterprise. Billy Ray Smith owned 100% of the stock of Hapjack. BR Smith Depo. Claude and Billy Ray Smith were the only directors and owners of Hapjack. Deposition testimony of Brian Griggs, page 18, line 23 to page 19, line 24 ("Griggs Testimony"). Mark L. Ehrlich, who served as the purported president of both Hotel Connect and World Cash, understood the officers of Hapjack to be Claude Smith, Billy Ray Smith and Brian Griggs. Ehrlich testimony, page 73, lines 12-15. Robert Lilly, an insurance agent who sold notes issued by all three of the companies, testified that he understood the control people of Hapjack to be Claude Smith, Billy Ray Smith and Brian Griggs. Page 15. He testified that Claude Smith and Billy Ray Smith were the "head honchos." Page 16.

6. Hapjack located, recruited, motivated and contracted with agents to sell the notes, organizing a network of "people who had a client base." Ehrlich testimony, page 74, lines 17-18. Hapjack hosted a gathering of more than 100 prospective sales agents for the promissory notes at the Sundowner Hotel in Las Vegas during the first half of 1997. Testimony of Edward Prentice ("Prentice testimony.") The seminar lasted three days and two nights and Hapjack paid for room and food. Lilly, page 50.

7. Defendant David Farrell was a marketing agent for Hapjack. Griggs testimony, page 146, lines 14-24; Lilly, page 17. Farrell provided services to Hapjack in the nature of supporting its broker dealers. Testimony of Prentice.

8. At all times relevant to this lawsuit, all seven of the defendants conducted their business operations from the same premises, 3649 Beechwood Avenue in Fresno. During some relevant time periods they leased additional space at nearby 3621 Beechwood Avenue.

9. Each of the note offerings by IBS, Hotel Connect and World Cash was made through the use of an offering circular titled "Confidential Private Placement Disclosure Document" ("offering circular") which constituted the primary disclosure document provided to prospective investors. Appelblatt testimony; Griggs testimony, page 50, pages 18-52, page 80, lines 7-16; Exs. 4, 6, 8 and 9.

10. Each of the offing circulars contained a representation that attorney Gary M. Appelblatt ("Appelblatt") had agreed to serve as Trustee pursuant to the terms of a Trust

Indenture that was made Exhibit "F" to each of the offering circulars. (Ex. 4, page 11 (this page is numbered "5" at its bottom center); Ex. 6, page 12 (this page is numbered "5" at its bottom center); Ex. 8, page 11 (this page is numbered "4" at its bottom center); Ex. 9, page 11 (this page is numbered "4" at its bottom center).

11. Appelblatt testified that he was contacted by Claude Smith, with whom he was previously acquainted, in approximately November of 1996, about whether he would consider serving as trustee for investors in 9-month notes issued by IBS. Appelblatt met on November 26, 1996 in Modesto with Claude Smith, Billy Ray Smith, Brian Griggs and Jeff McKay to discuss the proposal further. Exhibit 32, page 2. Following those discussions Appelblatt agreed to serve as trustee for IBS, pursuant to a retention letter he wrote dated November 29, 1996. (Ex. 29.) Thereafter Appelblatt also performed similar duties for Hotel Connect and World Cash on the same terms, though he never wrote separate retention letters relating to those other two companies. Appelblatt testimony.

12. Section 7.01 of the Trust Indentures for IBS, Hotel Connect and World Cash provided that the trustee Appelblatt would maintain four trust accounts: (a) the Note Distribution Account, (b) the Issuer Account, (c) the Reserve Account, and (d) the Agent Commission Account. Copies of the Trust Indentures are Exhibits "F" to each of the offering circulars, which are Exs. 4, 6, 8, and 9. Section 7.02 of each trust Indenture provided that the trustee was to segregate 7% of the investor funds in the Agent Commission Account, 10% to the Reserve Account, and the balance to the Issuer Account. Exhibits 73-75 are separate copies of the Trust indentures of each of the three note issuers. Additional copies of the Trust Indentures are part of the investor files of Leanoard Mastrandrea and Susan Chase, admitted as Exhibits 47 and 48.

13. In fact, however, the trustee Appelblatt maintained only a single trust account, to which he deposited all funds received from investors for the purchase of the notes. Appelblatt retained 10% of every note purchase in that trust account, and transmitted the remaining 90% directly to whichever of the three companies had issued the note. Appelblatt testimony.

14. Section 3.06 of the Trust Indentures of IBS, Hotel Connect and World Cash provided that each of the three note issuers would furnish the trustee audited annual financial statements

and unaudited in-house quarterly financial statements "as soon as such are available" and that "The Trustee shall retain such information for the benefit of the Noteholders." In fact, however, none of the three companies ever had any audited or unaudited financial statements prepared, so no such statements were ever provided to the trustee Appelblatt. Appelblatt testimony; Coffin testimony.

15. Purchasers of the promissory notes issued by the three companies were promised interest at the rate of 13.35% per year, payable quarterly. Each note contained a provision allowing renewal for one additional 9-month period at the option of the investor, and provided that the interest rate would increase to 15% during the renewal period. Exs. 4, page 28 (Ex. B of subscription agreement); Ex. 6, page 28, Ex. "A"; Ex. 8, page 28, Ex. "B."

16. The offering circulars represented to investors that their interest and principal would be paid and repaid out of the operating revenues of the three businesses. Exs. In fact, however, none of the three businesses ever derived operating revenues sufficient to meet their interest and principal repayment obligations. The defendants quickly fell behind in repaying principal to investors as the notes came due, and eventually halted payments of principal and interest entirely.

17. Numerous letters were admitted into evidence in which the trustee Gary Appelblatt pointed out to the three companies the names of investors whose note repayments were overdue. Exs. 21, 24, 25, 26, 33-37. Yet the defendants continued to use the same offering circulars to new investors throughout the period during which the notes were being sold, thereby continuing to represent that principal and interest would be repaid from revenues of the three businesses even after it was clear that the businesses were not generating any profits and that repayments, if made at all, would necessarily be made from the funds of new investors.

18. The defendants finally stopped selling the notes in September of 1999. Thereafter, the defendants relocated to Las Vegas. Approximately $12,028,353.40 million in principal, plus interest, remains in default and unpaid to investors. Of the 528 investors who purchased promissory notes, 299 have not received a return of their principal.

19. The offering circulars for all of the 9-month promissory note offerings of the three companies stated that:

> These securities have not been approved or disapproved by the Commissioner of Corporations of the State of California or by any other state regulatory agency or the Securities and Exchange Commission.

Ex. 4, page 4, Ex. 6, page 5, Ex. 8, page 5, Ex. 9, page 5.

Each of the offering circulars also stated:

> By virtue of the fact that the aggregate sum of the notes shall be five million dollars or less and that the note will only be offered to maximum [sic] of 35 unaccredited investors and an undetermined number of accredited investors, the company believes that the notes are securities exempt from registration under the Securities Act of 1933 pursuant to 17 C.F.R. § 230.505.

Edward Prentice testified, however, that he sold 9-month promissory notes for HC and was never given any training or supervision as to who was suitable for purchasing. He testified that he gave the Hotel Connect offering circular to prospective investors prior to their purchases and had an opportunity to read it himself. Based upon his reading of the offering circular, it appeared to him that the notes should only be sold to accredited investors, that is, investors with a million dollars net worth or a quarter of a million in income. But he talked to defendant Farrell at the Las Vegas convention held by Hapjack for prospective sales agents, and Farrell told him that it was not a problem, that he could sell the notes to nonaccredited investors.

20. Each of the offering circulars contained a table describing the proposed Use of Proceeds of the promissory note sales which contemplated sales commissions of 7%. Ex. 4, page 10; Ex. 6, page 13; Ex. 8, page 13; Ex. 9, page 13 (each of these four pages is numbered "6" at its bottom center). In addition, Section 7.01 of each of the Trust Indentures indentures specified that 7% of the amount paid by each investor for the promissory notes would be segregated in a trust account called the "the Agent Commissioner Account." Exs. 73-75. In fact, however, total sales commission expenses were approximately 35% for IBS, approximately 24% for HC and approximately 27% for WCN. Robertson testimony; Ex. 99. The trustee Gary Appelblatt took notes at a meeting on November 26, 1996, with Claude Smith, Billy Ray Smith, Brian Griggs and Jeff McKay, reflecting that sales commissions of 15% were discussed. That meeting took

place before selling of the notes commenced. Appelblatt testimony; Ex. 32, page 2. Such high commission expense, which was not revealed to the investors, substantially reduced the amount of note revenue available for operating expenses of the three businesses, and thereby substantially reduced the odds that they would ever achieve profitability.

21. Hapjack received a commission of about 10% for the sale of each note, and also earned a fee on renewals of the 9-month notes. BR Smith Deposition; Goodman testimony) Agents recruited by Hapjack also received commissions "over and above" the fee to Hapjack. BR Smith Deposition; Prentice testimony; Goodman testimony. Robert Lilly, for example, testified that he received 10% commissions for sales he made of the 9-month promissory notes of all three companies. Lilly testimony, page 20. He also received commissions on renewals. Lilly testimony, pages 38, 42-43.

22. Mike Goodman he owns and operates a business under the fictitious name GAC Marketing (GAC) which uses networks of sales agents to sell various products and financial programs. Mike Goodman Deposition (Goodman Deposition), pages 15-16. GAC became involved in the 9-month promissory note program through Claude Smith (page 34), and sold 9-month promissory notes of IBS, Hotel Connect and World Cash. Goodman Deposition, pages 72, 87. GAC also provided training for agents who sold the notes. Goodman Deposition, pages 36-39. GAC's main address is in Merced but Claude Smith allowed it to use space at 3649 Beechwood in Fresno. Goodman Deposition, page 5. GAC had no written commission agreement with Hapjack. Instead, Goodman negotiated a verbal agreement with Claude Smith. Goodman Deposition, page 47. Under that agreement, GAC received a portion of the commission received by each agent it trained who sold a note. Goodman Deposition, pages 31, 37. In addition to the commissions received by each agent and GAC, Hapjack also received a commission on sales made by agents trained by GAC because "they made all this possible." Goodman Deposition, page 46. GAC received a commission of 2.5% on initial sales and renewals of notes. Goodman Deposition, page 89. Goodman was told by Claude Smith that each note could be renewed one or two times. Goodman deposition, page 89.

23. Some of the HC 9-month promissory notes were sold through a marketing business called River City Financial, LLC, which Billy Ray Smith owned with Edward Prentice ("Prentice"). Prentice testified that Billy Ray Smith owned 80% of the business and Prentice owned 20%. River City received a 10% commission on Hotel Connect notes sold by River City, and also received an override on commissions earned by agents it recruited. The commissions on Hotel Connect promissory notes were paid by Hapjack Marketing but Hapjack did not contract directly with the agents. The agents contracted with Hotel Connect. Claude Smith and Billy Ray Smith identified themselves to Prentice as representatives of Hapjack. Prentice testimony.

24. The court admitted live and declaration testimony from eight witnesses who invested in 9-month promissory notes issued by IBS, Hotel Connect and World Cash, including:

25. Raymond Miller, who testified concerning $100,000 he and his wife invested in an IBS note purchased from agent Robert Lilly, mailing their money to David Farrell at Hapjack Marketing at 3649 Beechwood in Fresno, payable to IBS. Soon after their investment, the Millers received a "welcome" letter from Billy Ray Smith, dated May 28, 1998. Smith signed the letter as "president" (Ex. 20), even though the offering circular states that Jeff McKay was the IBS president. (Ex. 4.)

26. Leonard Mastrandrea, who that he testified that on or about August 21, 1998, he invested $25,000 in a 9-month promissory note issued by Hotel Connect through his agent Ed Prentice.

27. Eugene and Susan Chase, who testified that they invested $40,000 in a 9-month promissory note issued by Hotel Connect on or about December 17, 1998, in reliance upon their agent Ed Prentice, whom Eugene Chase believed to be a financial planner and adviser, and who later told them he would write a letter on their behalf claiming hardship in an effort to get their money back. Ed Prentice confirmed that he told Hapjack Marketing that the Chases had a hardship because he thought that by saying that he could get their money back for them. Prentice testified that Billy Ray Smith told him it would be no problem, but Smith did not say where

Hotel Connect would obtain the money to pay the Chases back. Despite the assurance of Billy Ray Smith, the Chases never received a return of their principal.

28. Linda Brunetti, who testified that her husband invested $40,000 of IRA money in a Hotel Connect 9-month promissory note in August of 1999. She and her husband Tony invested $110,000 into a 9-month promissory note of World Cash in September of 1999. The investments were made through agent Ted Schindler who was a friend and associate of Tony Brunetti and through whom the Brunettis had previously made conservative investments, mostly government-backed securities.

29. Mildred N. Gray, who testified that she is an 82 year old widow who purchased a 9-month promissory note issued by World Cash on or about May 19, 1998 from an agent named Dennis Whitfield. Ex. 119.

30. William D. Zalabak, a 74 year old retiree who purchased a note issued by Hotel Connect in the amount of $204,250.94 on or about December 9, 1997 and a note issued by World Cash in the amount of $89,043.17 from a man named Joe Don Garrett. Ex. 132.

31. Vera Keller, a widow who purchased a note issued by Hotel Connect in the amount of $25,000 on or about September 9, 1997 from a man named Donald Beacon. Ex. 121.

32. Carolyn Olson, who offered a declaration on behalf of the estate of Ruth McClure, who purchased a purportedly "secured" promissory note from IBS on or about December 17, 1997 in the amount of $89,743.00. Ex. 123.

33. The investor witnesses offered similar accounts of having invested in the notes after being approached by agents who stated that they would provide quarterly interest of 13.35% during the first 9-month period which would increase to 15% if the notes were renewed for a second nine-month period. Most of the investors who testified (the Millers, Mastrandrea, Zalabak, Keller and McClure) did renew their notes at the end of the original 9-month period after receiving the promised interest payments during the first nine-month period. Four of the investors, (Millers, Zalabak, Vera Keller and Ruth McClure), renewed their notes a second time, even though the notes provided only for a single 9-month renewal. Zalabak was offered an opportunity to extend his note a third time, for a fourth 9-month period, in January of 2000, but

declined. Two other investors, Mildred Gray and the Chases, denied that they renewed their notes but nevertheless did not receive a return of their principal at the end of nine months though they did continue to received some interest payments. Two of the investors, Mastrandrea and Gray, testified that their subscription agreements contain false information inflating their net worth and prior investment experience. Ex. 47 (Mastrandrea). All of the investors testified that their interest payments had eventually stopped and that their efforts to recover their principal had been unsuccessful, either in whole or in substantial part. The Brunettis did succeed in recovering the 10% of their principal that had been held by the trustee Appelblatt.

34. The evidence established that defendants Claude and Billy Ray Smith dominated and controlled the operations of the other defendants and disregarded the separate and distinct status of IBS, HC, WCN and Hapjack. As one example, Billy Ray Smith testified in his deposition that when financial trouble occurred at IBS, Hapjack paid some of its commissions back so that investors could be repaid amounts they had invested in promissory notes. He described the payment as a "loan" but acknowledged that there was no supporting documentation. BR Smith Deposition, pages 168-169.

35. Harold P. Coffin ("Coffin"), an accountant, testified that such undocumented transfers of funds between legally distinct business entities was typical of the manner in which the defendants conducted their business operations. Coffin testified that he became employed by the defendants in late 1997 through his prior acquaintance with Mark Ehrlich, who held the title of President of IBS. Coffin was originally employed by World Cash, as its chief financial officer, but over a period of four to six months his job duties expanded to include the other two note issuing companies as well. Coffin testimony. Coffin was the chief financial officer of World Cash. Griggs testimony, page 77, lines 20-23.

36. Ehrlich had a title but Claude Smith did the day-to-day decision-making and the Coffin always understood the three principals of IBS, Hotel Connect and World Cash to be Brian Griggs and the Smith brothers, Claude and Billy Ray. Those three did not have titles in any companies but they hired people and gave them titles. Staff meetings were headed up by Claude Smith. Coffin testimony.

37. Coffin's testimony was corroborated by Brian Griggs, who testified that when he performed consulting services for World Cash he reported to Claude Smith and no one else. Page 119, lines 15-20. Griggs testified further that he worked for Hapjack at the request of Claude Smith. Page 17, line 24 to page 18, line 1. Griggs testimony, page 119, lines 15-20. Griggs negotiated consulting contracts for IBS and World cash with Claude Smith. Page 9, lines 3-6; page 9, line 24 to page 10, line 1. In addition, Coffin was hired by Claude Smith, who got his name from Mark Ehrlich. Griggs testimony, pages 48-49.

38. Mark Ehrlich was hired by Claude Smith and Brian Griggs to serve as the president of Hotel Connect, and that the two of them told him what his duties and responsibilities were. Ehrlich testimony, page 21.

39. When Coffin began working for the companies, the accounting for IBS, Hotel Connect and World Cash was being done by Tony Pien. After Coffin began working for the defendants as chief financial offier, Pien worked for Coffin as the "controller" of World Cash. Coffin observed that Pien maintained a big columnar sheet with columns for each of the bank accounts maintained for each of the defendant companies as well as other business entities of the defendants. Each morning Pien called the bank to get the bank balances for each account, some of which would be negative and some positive. Pien would then meet with Claude Smith, Billy Ray Smith and Brian Griggs and the three of them would instruct Pien to transfer money into and out of the various accounts. The inter-company transfers were a daily occurrence and were not explained or labeled, so Coffin identified them as "loans" in the records he created. Coffin testified that he was unsuccessful in efforts to stop the practice but that he attempted to impose some order on it, and created records that constitute the best accounting records the company had. Coffin never created or saw any financial statements for any of the three companies that issued the promissory notes, either audited or unaudited. Coffin testimony.

## CONCLUSIONS OF LAW

1. The 9-month promissory notes offered and sold by the defendants are securities as defined by the California Corporate Securities Law, Corporations Code § 25000 et seq. (CSL). Corporations Code § 25019; *Leyva v. Superior Court* (1985) 164 Cal.App.3d 462, 470. Each of

the offering circulars reflects that the notes constitute securities. Ex. 4, page 4; Ex. 6, page 5; Ex. 8, page 5; Ex. 9, page 5.

2. The general purpose of the CSL is to protect the public from unsubstantial, unlawful and fraudulent investment schemes by promoting full disclosure of all information necessary to make informed and intelligent investment decisions. (*People v. Park* (1978) 87 Cal.App.3d 550, 565; *People v. Syde* (1951) 37 Cal.2d 765, 768.) Its basic regulatory purpose is to protect the public against spurious schemes, however ingeniously devised, to attract risk capital. (*Leyva v. Superior Court* (1985) 164 Cal.App.3d 462, 470.)

3. To achieve its purposes, the CSL prohibits the offer and sale of securities unless they have either been properly qualified, or are exempt from the qualification requirement. (Corporations Code § 25110.) The burden of proving an exemption or exception to the qualification requirement is upon the person claiming it. (Corporations Code § 25163.) The fundamental purpose of the qualification requirement is to ensure that a securities seller has made a full, complete, accurate disclosure of all information relevant and material to the buyer's decision to purchase. (*Fine v. Superior Court* (1997) 52 Cal.App.4$^{th}$ 1258, 1265.) Avoidance of that disclosure process by an unqualified seller necessarily makes fraud possible. (*Id.*) For example, 10 Cal. Code Regs., title 10, § 260.140.05 provides that an open qualification normally will not be approved if the business in which the issuer is engaged in not reasonably anticipated to produce profits within a reasonable period of time, presumptively twenty-four months. It provides further that the Department of Corporations may require prospective financial information submitted by an application to be examined by an independent certified public accountant as a pre-condition to qualification.

4. The defendants, and each of them, knowingly offered and sold securities in violation of California Corporations Code §25110. The offering circulars associated with each of the note offerings contain the representation that the defendants believed the note offerings to be exempt from registration because they were only going to be offered to a maximum of 35 unaccredited investors. Ex. 4, page 18 (the page is numbered "12" at its bottom center; Ex. 6, page 19 (the page is number "12" at its bottom center); Ex. 8, page 19 (the page is numbered "12" at its

bottom center); Ex. 9, page 19 (the page is numbered "12" at its bottom center). This language appears to constitute an attempt to take advantage of the limited offering exemptions available under state and federal law for offering limited to investors meeting specified income, net worth and investment sophistication criteria. The attempt fails, however, because the trial testimony of Edward Prentice established that the companies' sales agents were not informed of such a limitation and, to the contrary, were affirmatively told by defendant Farrell that the there was no limitation on the investors to whom the notes could be offered. Moreover, two investors, Mastrandrea and Gray, testified that the information that was written on their Note Purchaser's Suitability Questionnaires (Exhibit "E" to each of the offering circulars) was false, indicating that the defendants were fabricating investor qualification information.

5. The defendants, and each of them, knowingly offered and sold securities by means of written and oral communications which included untrue statements of material fact and through omissions to state material facts necessary in order to make the statements made, in light of the circumstances which they were made, not misleading, in violation of California Corporations Code §25401. Those communications included untrue statements concerning the exemption of their security offerings from the qualification requirement of Corporations Code § 25110, untrue statements concerning the trust accounts that were supposed to have been maintained by the trustee, Appelblatt, and untrue statements that quarterly financial statements and annual audited financial statements would be provided to the trustee Appelblatt. Defendants omitted to state material facts including the actual amount of the sales commissions being paid to sales agents for the notes, that notes were remaining unpaid months after they became due and investors requested repayment, that the companies were not generating revenues from which the notes could be repaid, and that repayments were being made, if at all, from funds paid in by new investors.

6. If the acts of the defendants did not constitute the direct offer and sale of securities in violation of California Corporations Code §§25110 and 25401, their activities would constitute knowing provision of substantial assistance to another in violation of the provisions of the California Corporations Code §25403.

7. Under the alter ego doctrine, the distinct entity of the corporate form may be disregarded, and acts of the corporation and its stockholders and officers may be attributed to one another, when justice and equity can best be accomplished, and fraud and unfairness defeated, by a disregard of the distinct entity of the corporate form. *Mid-Century Ins. Co. v. Gardner* (1992) 9 Cal.App.4th 1205, 1212.

8. It is not sufficient to show merely that a creditor will remain unsatisfied if the corporate veil is not pierced; in almost every instance where a party attempts to invoke the doctrine he is an unsatisfied creditor. Instead, the purpose is to afford an unsatisfied creditor some protection where conduct amount to bad faith makes it inequitable for the equitable owner of a corporation to hide behind its corporate veil.

9. There is no litmus test to determine when the corporate veil will be pierced, but there are two general requirements: (1) that there be such unity of interest and ownership that the separate personalities of the corporation and the individual no longer exist and (2) that, if the acts are treated as those of the corporation alone, an inequitable result will follow. *Mesler v. Bragg Management Co.* (1985) 39 Cal.3d 290, 300.

10. Considerations relevant to the alter ego analysis include commingling of funds and other assets; the failure to segregate funds of the individual and the corporation; the unauthorized diversion of corporate funds to other than corporate purposes; the treatment by an individual of corporate assets as his own; the ownership of all the stock by a single individual or family; the domination or control of the corporation by the stockholders; the use of a single address for the individual and the corporation; the disregard of formalities and the failure to maintain arm's-length transactions with the corporations. (*Mid-Century, supra,* 9 Cal.4th at 1213, n.3.)

11. The alter ego doctrine applies to limited liability companies to the same extent as to corporations. (Corporations Code § 17101.)

12. The evidence warrants application of the alter ego doctrine to disregard the separate business forms of the four business-entity defendants, IBS, Hotel Connect, World Cash and Hapjack, and to hold each of them, and each of the three individual defendants jointly and severally liable for all of the debts, damages and liabilities of the others relating to and arising out of the offer and sale of the 9-month promissory notes issued by IBS, Hotel Connect and

World Cash. The evidence reflects that at all times the defendants conducted their operations from common premises in Fresno, California, and that defendants Claude Smith and Billy Ray Smith dominated and controlled the four business-entity defendants, holding and exercising all real decision-making authority while avoiding formal titles and giving those titles to their employees. The evidence further reflects that Claude Smith and Billy Ray Smith manipulated the funds and bank accounts of the business defendants in total disregard of their formal legal separateness. The evidence also reflects that defendant David Farrell provided marketing services and support relating to sales of the promissory notes, and in that capacity advised sales agents that there were no limitations upon the investors to whom the notes could be offered, advice which was contrary to statements in the offering circulars and rendered specious the claim of the defendants that the note offerings were exempt from the qualification requirement of the CSL.

13. Under these circumstances an inequitable result would follow if any of the seven defendants were allowed to assert its formal legal distinctness and separateness from any of the other defendants as a ground for avoiding liabilities relating to the offer and sale of the 9-month promissory notes issued by IBS, Hotel Connect and World Cash.d manipulated funds and bank accounts without regard to

14. Corporations Code § 25530(a) provides that a permanent injunction shall be granted upon a proper showing that any person has engaged in any act or practice constitution a violation of the CSL. In the present action the defendants stipulated to a preliminary injunction which has been in effect since October 12, 2000. Overwhelming evidence of hundreds of violations of the CSL by the defendants warrants issuance of a judgment making that injunction permanent.

15. Section 25530(b) provides:

> If the commissioner determines it is in the public interest, the commissioner may include in any action authorized by subdivision (a) a claim for ancillary relief, including but not limited to, a claim for restitution or disgorgement or damages on behalf of the persons injured by the act or practice constituting the subject matter of the action, and the court shall have jurisdiction to award additional relief.

The CSL was patterned after the federal Securities Act of 1933. (*Moreland v. Department of Corporations* (1987) 194 Cal.App.3d 506, 512.) Federal law is therefore treated as "persuasive"

in cases interpreting the CSL, and is often consulted. (*See, e.g., Leyva, supra,* 164 Cal.App.3d 462, 471; *People v. Schock* (1984) 152 Cal.App.3d 379, 387.)

16. The term "disgorgement" was not added to § 25530 until 1981, but it has been held that the amendment was only declarative of existing law, because the relief it authorizes was already encompassed in the statutory term "restitution." (*People v. Martinson* (1986) 188 Cal.App.3d 894, 900-901.) The primary purpose of disgorgement as a remedy for violation of the securities laws is to deprive violators of their illegal gains, thereby effectuating the deterrence objectives of those laws. (*SEC v. Milan Capital Group, Inc.* (S.D.N.Y., Aug. 14, 2001, No. 00 Civ. 0108) 2001 U.S. Dist. Lexis 11804.) A person may be held jointly and severally liable for disgorgement with an entity he or she controls. (*Hately v. SEC* (9th Cir. 1993) 8 F.3d 653, 656.)

17. The evidence reflect that the defendants received a total of over $20 million from investors, of which approximately $12,028,353.40 remains unpaid. A judgment requiring disgorgement in that amount against all of the defendants, jointly and severally, is appropriate

18. Corporations Code § 25535 provides that any person who violates any provision of the CSL "shall be liable for a civil penalty not to exceed twenty-five thousand dollars ($25,000) for each violation." Under California law, the question of what constitutes "a violation" for purposes of a civil penalty provision is generally determined on the basis of all the circumstances of the case, including the type of violation involved, the number of victims, the amount of harm inflicted on each of the victims, and the degree of repetition. (S*ee, e.g., People v. Witzerman* (1972) 29 Cal.App.3d 169, 180.)

19. In the present case, the sale of each promissory note violated both Corporations Code § 25110 and § 25401. In addition, the notes were renewed up to twice per investor, creating a total number of three transactions arguably amounting to a maximum of six violations per investor. This Court determines, however, that a relatively conservative interpretation of the term "violation" is appropriate in this case, deeming each investor rather than each transaction to constitute each violation, for a total of 528 violations by the defendants. This interpretation is appropriate since the maximum civil penalty of $25,000 per violation is the same as the

minimum investment amount.[2] Defining the term "for each violation" in this manner results in a maximum civil penalty of $13.2 million against each of the defendants.

20. This Court determines that imposition of the maximum civil penalty of $25,000 is appropriate. In *State of California v. City and County of San Francisco* (1979) 94 Cal.App.3d 522, 531, a case in which the state sought imposition of civil penalties for water pollution, the trial court ruled that once the plaintiff state had proved a discharge in violation of the Water Code, the burden shifted to the defendant to establish, by a preponderance of the evidence, that the amount of penalty imposed should be less than the maximum. The Court of Appeal affirmed, stating:

> Penalties are designed to deter as well as compensate. A penalty statute presupposes that its violation produces damage beyond that which is compensable. ¶ . . . ¶ The burden of demonstrating that its pollution of the bay and ocean was of a magnitude less than the liquidated damages provided for in section 13385 was properly placed with the city. The city introduced no evidence in mitigation of damages and is, therefore, liable in the amount of $ 10,000 for each day in which it violated the Water Code.

(94 Cal.App.3d 522, 531, 531-32.)

21. A similar rule is appropriate in the present case for the additional reason that the defendants have voluntarily and knowingly elected not to appear at the trial at all despite full knowledge of the nature and magnitude of the claims asserted against them. By their action they have implicitly conceded that have no evidence to assert in mitigation of the maximum penalty provided for by law.

Dated: October 29, 2001

By:_____
JUDY HERSHER
Judge of the Superior Court

[2] It is also conservative, however, since many victims invested much more than the minimum amount.