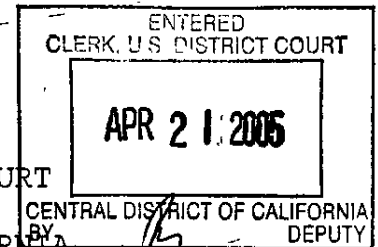
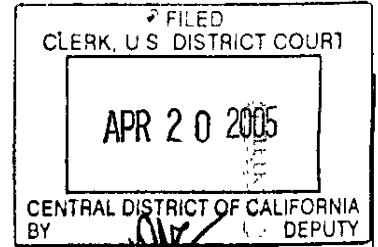


Priority
Send
Enter
Closed
JS-5/JS-6
JS-2/JS-3
Scan Only



UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA

SECURITIES AND EXCHANGE
COMMISSION,

Plaintiff,

v.

NATIONAL FINANCIAL SYSTEMS,
INC. and TERESE HERWICK,

Defendants.

CV 03-6908 SVW (JTLx)

ORDER GRANTING IN PART
PLAINTIFF'S MOTION FOR SUMMARY
JUDGMENT OF DISGORGEMENT AND
IMPOSING A CIVIL PENALTY
AGAINST TERESE HERWICK.

THIS CONSTITUTES NOTICE OF ENTRY
AS REQUIRED BY FRCP, RULE 77(d).

I. INTRODUCTION

In this securities case, the Securities and Exchange Commission ("SEC") and Defendant Terese Herwick ("Herwick") consented to a judgment pursuant to which the parties agreed that for purposes of determining the amounts of disgorgement and civil penalties owed by Herwick, the Court would accept as true the facts alleged in the SEC's Complaint. Now before the Court is the SEC's Motion for Summary Judgment of Disgorgement and Imposing a Civil Penalty Against Terese Herwick. Because the Court is to accept the allegations in the SEC's complaint as true, the Court need only apply the appropriate statutes to the facts alleged in the Complaint in order to determine the propriety and appropriate levels of disgorgement and civil penalties.

117

II. FACTUAL & PROCEDURAL BACKGROUND

On September 25, 2003, the SEC filed a Complaint for Violation of the Federal Securities Laws against Defendants National Financial Systems, Inc. ("NFSI"), and its owner and president, Terese Herwick. The Complaint alleges three claims for relief, including fraud in the offer or sale of securities under section 17(a) of the Securities Act, fraud in connection with the purchase or sale of securities under section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and fraud by an investment adviser under sections 206(1) and 206(2) of the Advisers Act.

The Complaint alleges that NFSI and Herwick, who managed the "'Fixed Fund,' an unregistered pool of assets consisting of real estate, equity securities, mutual funds, and bonds," deceived "clients and prospective clients by concealing a massive decrease in NFSI's assets and misrepresenting the returns purportedly accruing to investors." (Complaint at ¶¶ 3-4). The Complaint further alleges that at the time NFSI assumed management of the "Fixed Fund,"

Herwick knew that a significant number of Fixed Fund assets had not performed for years or had been foreclosed upon. NFSI never disclosed these facts to the Fixed Fund's approximately 100 investors. In January 2002, NFSI wrote off the worthless assets, which NFSI has also never disclosed to Fixed Fund investors. The value of the Fixed Fund's assets has fallen to approximately 50% of the amount owed to Fixed Fund investors as principal and purported accrued dividends. As of March 31, 2003, the value of the Fixed Fund's assets totaled no more than \$7.4 million while its liabilities totaled at least \$14.1 million. NFSI has never disclosed this fact to Fund investors. Instead, NFSI has

1 continued to promote the Fixed Fund as an investment vehicle that
2 purportedly seeks preservation and protection of capital while
3 providing regular monthly cash distributions. Moreover, NFSI has
4 provided Fixed Fund investors with quarterly account statements
5 that purport to credit those investors with their contracted-for
6 rates of return - returns which have not been generated by the
7 Fund's underlying assets and which neither the Fund nor NFSI can
8 possibly repay.

9 (Id. at ¶ 4). "In addition, NFSI has failed to disclose that it takes
10 from the Fixed Fund a management fee of 2% of all assets (including
11 non-Fixed Fund assets) that it administers. This amounts to an
12 effective undisclosed fee of 10% or more charged solely to Fixed Fund
13 investors." (Id. at ¶ 5).

14 On July 22, 2004, the SEC and Herwick consented to the Court's
15 entry of a Judgment of Permanent Injunction and Other Relief Against
16 Terese Herwick. The Judgment stated that Herwick consented to the
17 entry of the Judgment "without admitting or denying the allegations in
18 the Complaint, except as specifically set forth in the Consent of
19 Terese Herwick to Entry of Judgment of Permanent Injunction And Other
20 Relief ('Consent')." (Judgment at 1-2). The Judgment enjoined
21 Herwick from violating Section 17(a) of the Securities Act of 1933,
22 from violating Section 10(b) of the Securities Exchange Act of 1934
23 and Rule 10b-5 thereunder, and from violating Sections 206(1) and (2)
24 of the Investment Advisers Act of 1940. (Judgment at 2-3). In
25 addition, the Judgment stated as follows:

26 It is further ordered, adjudged, and decreed, that the Court
27 retains jurisdiction to determine appropriate amounts of
28 disgorgement, prejudgment interest, and civil penalties that

1 shall be paid by Herwick for the conduct alleged in the
2 Commission's Complaint. Prejudgment interest shall be calculated
3 pursuant to 28 U.S.C. § 1961 based on the date of entry of the
4 order fixing the amount of disgorgement. In connection with any
5 hearing to determine the appropriate amounts of disgorgement and
6 civil penalties, Herwick shall not raise as a defense that she is
7 not liable for payment of disgorgement or civil penalties because
8 she did not violate the provisions of the Securities Act, the
9 Exchange Act, the Advisers Act, or rules thereunder as set forth
10 in the Complaint. Solely for the purposes of determining the
11 amounts of disgorgement and civil penalties, the Court shall
12 accept and deem as true the facts alleged in the Commission's
13 Complaint. Herwick shall not be entitled to a trial by jury for
14 purposes of determining the appropriate amounts of disgorgement
15 or civil penalties.

16 (Judgment at 3-4).

17 On February 17, 2005, the SEC filed the instant Motion for
18 Summary Judgment of Disgorgement and Imposing a Civil Penalty Against
19 Terese Herwick. The Court granted Herwick until April 4, 2005, to
20 file an Opposition, and Herwick filed her Opposition on that date.
21 The SEC filed its Reply on April 8, 2005. The hearing on the SEC's
22 Motion was held on Monday, April 18, 2005.

24 III. DISCUSSION

25 A. Summary Judgment Standard

26 Rule 56(c) requires summary judgment for the moving party when
27 the evidence, viewed in the light most favorable to the nonmoving
28 party, shows that there is no genuine issue as to any material fact,

1 and that the moving party is entitled to judgment as a matter of law.
2 See Fed. R. Civ. P. 56(c); Tarin v. County of Los Angeles, 123 F.3d
3 1259, 1263 (9th Cir. 1997). "A material issue of fact is one that
4 affects the outcome of the litigation and requires a trial to resolve
5 the parties' differing versions of the truth." SEC v. Seaboard Corp.,
6 677 F.2d 1301, 1306 (9th Cir. 1982).

7 The moving party bears the initial burden of establishing the
8 absence of a genuine issue of material fact. See Celotex Corp. v.
9 Catrett, 477 U.S. 317, 323-24, 106 S. Ct. 2548, 2553, 91 L.Ed.2d 265
10 (1986). That burden may be met by "'showing'—that is, pointing out to
11 the district court—that there is an absence of evidence to support the
12 nonmoving party's case." Id. at 325, 106 S.Ct. at 2554. Once the
13 moving party has met its initial burden, Rule 56(e) requires the
14 nonmoving party to go beyond the pleadings and identify specific facts
15 that show a genuine issue for trial. See id. at 323-34, 106 S.Ct. at
16 2553; Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 248, 106 S. Ct.
17 2505, 2510, 91 L.Ed.2d 202 (1986).

18 Only genuine disputes—where the evidence is such that a
19 reasonable jury could return a verdict for the nonmoving party—over
20 facts that might affect the outcome of the suit under the governing
21 law will properly preclude the entry of summary judgment. See
22 Anderson v. Liberty Lobby, Inc., 477 U.S. at 248, 106 S. Ct. at 2510;
23 see also Arpin v. Santa Clara Valley Transp. Agency, 261 F.3d 912, 919
24 (9th Cir. 2001) (the nonmoving party must offer specific evidence from
25 which a reasonable jury could return a verdict in its favor).

26 ///

27 ///

28 ///

1 B. Herwick's Violation of Anti-Fraud Provisions

2 In this case, because the parties have agreed that the Court will
 3 accept as true the allegations contained in the SEC's complaint for
 4 purposes of determining the proper level of disgorgement and civil
 5 penalties to be imposed upon Defendant Herwick, there are no disputed
 6 issues of fact regarding Herwick's violation of the securities laws.

7 The SEC's Complaint alleges that Herwick violated Section 17(a)
 8 of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-
 9 5 thereunder, and Sections 206(1) and 206(2) of the Advisers Act.
 10 (Complaint at ¶¶ 27-35). The Judgment to which the parties consented
 11 states as follows:

12 In connection with any hearing to determine the appropriate
 13 amounts of disgorgement and civil penalties, Herwick shall not
 14 raise as a defense that she is not liable for payment of
 15 disgorgement or civil penalties because she did not violate the
 16 provisions of the Securities Act, the Exchange Act, the Advisers
 17 Act, or rules thereunder as set forth in the Complaint.
 18 (Judgment at 4). Thus, the facts stated in the SEC's complaint
 19 constitute uncontroverted facts for purposes of determining the proper
 20 level of Herwick's disgorgement and civil penalties, and it is
 21 undisputed for purposes of determining the proper level of
 22 disgorgement and civil penalties that Herwick violated the statutes at
 23 issue in this case.

24
 25 C. Disgorgement and Prejudgment Interest

26 "Disgorgement plays a central role in the enforcement of the
 27 securities laws." S.E.C. v. Rind, 991 F.2d 1486, 1491 (9th Cir.
 28 1993). "The SEC's power to obtain injunctive relief has been broadly

1 read to include disgorgement of profits realized from violations of
2 the securities laws." S.E.C. v. Clark, 915 F.2d 439 (9th Cir. 1990)
3 (citing S.E.C. v. Randolph, 736 F.2d 525, 529 (9th Cir. 1984); Handler
4 v. S.E.C., 610 F.2d 656, 659 (9th Cir. 1979)). "The amount of
5 disgorgement should include all gains flowing from the illegal
6 activities." S.E.C. v. Cross Fin. Servs., 908 F. Supp. 718, 734 (C.D.
7 Cal. 1995) (citing S.E.C. v. Lund, 570 F. Supp. 1397, 1404 (C.D. Cal.
8 1983)). Therefore, in S.E.C. v. First Pac. Bancorp, the Ninth Circuit
9 upheld the district court's order requiring a defendant who was the
10 chairman of the board, CEO, and corporate counsel of defendant Bancorp
11 to disgorge funds based on the "hundreds of thousands of dollars in
12 salaries, commissions, and consulting, management and legal fees" the
13 defendant paid himself. 142 F.3d 1186, 1192 (9th Cir. 1998). In that
14 case, the Ninth Circuit stated that "[t]he district court was not
15 required to trace every dollar of the offering proceeds fraudulently
16 retained by [the defendant]." Id. at 1192 n. 6 (citations omitted).
17 "The amount he was ordered to disgorge had to be only 'a reasonable
18 approximation of profits causally connected to the violation.'" Id.
19 (citation omitted).

20 In this case, it is undisputed for purposes of calculating the
21 proper amount of disgorgement to be paid by Herwick that Herwick
22 violated the securities laws, as discussed above. The SEC has
23 requested disgorgement in the amount of \$289,226. This is the amount
24 that the SEC alleges Herwick received as compensation from NFSI from
25 January 1, 2000 through September 30, 2003. The SEC attempts to
26 establish the amount of Herwick's compensation during the relevant
27 period through a declaration under penalty of perjury submitted by
28 Craig M. Collins, a certified public accountant retained by the

1 Receiver in this case "to assist with the administration of the
2 Estate." (Collins Decl. at 1). Attached to Collins' declaration are
3 NFSI's tax returns reflecting the total wages paid to Herwick in 2000,
4 2001, and 2002. In addition, Collins' declaration attaches NFSI's
5 payroll register for the period of January 1, 2003 through September
6 13, 2003.

7 According to NFSI's 2000 tax return, NFSI paid Herwick \$70,175 in
8 2000. (Collins Decl., Exh. A). According to NFSI's 2001 tax return,
9 NFSI paid Herwick \$70,579 in 2001. (Collins Decl., Exh. B).
10 According to NFSI's 2002 tax return, NFSI paid Herwick \$90,262 in
11 2002. (Collins Decl., Exh. C). According to NFSI's payroll register,
12 NFSI paid Herwick \$54,990.76 for the period of January 1, 2003 through
13 September 13, 2003. (Collins Decl., Exh. D). Collins' declaration
14 further asserts that "[l]ater in the month of September 2003
15 additional wages were paid to increase the total wages paid through
16 September 30, 2003 to \$58,210." (Collins Decl. at 1). However, the
17 SEC has provided no evidence of the additional wages allegedly paid to
18 Herwick between September 13, 2003 and September 30, 2003. Thus, the
19 total amount of wages paid by NFSI to Herwick for which the SEC has
20 provided evidence amounts to \$286,006.76.

21 Herwick makes two arguments against disgorgement. First, Herwick
22 argues that part of her salary for the period in question "was
23 compensation earned by Herwick for her personal insurance sales."
24 (Opp. at 2). Herwick alleges that "[t]he compensation policy in
25 effect when Herwick joined Armer in 1980 as an employee and continued
26 until her termination was that personal insurance commissions earned
27 by Herwick (and any other licensed insurance agent of the company)
28 would be endorsed to NFS (formerly Armer) and this income would then

1 be returned to the agent as part of their NFS salary." (Id.). Rather
2 than providing evidence of this convoluted arrangement, Herwick argues
3 that the records are unavailable to her "but are kept in the NFS
4 office." At the April 18, 2005 oral argument regarding the SEC's
5 Motion, Herwick represented that approximately half of her salary
6 received during the relevant time period was attributable to insurance
7 commissions, and counsel for the SEC stated that the SEC would not
8 oppose the Court's reduction of the total amount of disgorgement by
9 half to reflect the alleged insurance commissions. While the Court
10 has reservations about accepting Herwick's self-serving
11 representations, the Court will reduce the amount of disgorgement by
12 half based on the SEC's concession.

13 Second, Herwick argues that she did not personally profit from
14 the fraud perpetrated upon the investors in the Fixed Fund, because
15 she incurred "extraordinary liabilities" on behalf of NFSI, so the
16 funds she received from NFSI do not constitute "profits." (Opp. at
17 3). However, Herwick provides no legal authority for the proposition
18 that the Court is permitted to order her to disgorge her NFSI salary
19 only if she has not incurred debt higher than the amount of the
20 salary, and the Court has found none.

21 Because the evidence submitted by the SEC establishes that
22 Herwick's salary received from NFSI amounted to \$286,006.76, and
23 because the SEC has conceded to have the Court reduce the amount of
24 the disgorgement by one half to reflect the amount of Herwick's salary
25 allegedly consisting of commissions received from insurance sales, the
26 Court ORDERS Herwick to disgorge her ill-gotten gains in the amount of
27 \$143,003.38.

28 ///

1 Further, because the SEC has not provided adequate evidence of
2 the appropriate level of prejudgment interest to be imposed, including
3 the appropriate interest rate to be applied and the date from which
4 prejudgment interest should begin to run, the Court DECLINES to order
5 Herwick to pay prejudgment interest on the amount of the disgorgement.¹

6
7 D. Civil Penalty

8 Section 21(d)(3)(A) of the Exchange Act provides that "[w]henever
9 it shall appear to the Commission that any person has violated any
10 provision of this chapter . . . the Commission may bring an action in
11 a United States district court to seek, and the court shall have
12 jurisdiction to impose, upon a proper showing, a civil penalty to be
13 paid by the person who committed such violation." 15 U.S.C. §
14 78u(d)(3)(A). The Exchange Act provides for three tiers of civil
15 penalties. Under the first tier, the maximum amount of the penalty is
16 \$5,000 for natural persons. 15 U.S.C. § 78u(d)(3)(B)(i). Under the
17 second tier, the maximum amount of the penalty is \$50,000 for a
18 natural person if the violation "involved fraud, deceit, manipulation,
19 or deliberate or reckless disregard of a regulatory requirement." 15
20 U.S.C. § 78u(d)(3)(B)(ii). Under the third tier, the maximum amount
21 of the penalty was \$100,000 or "the gross amount of pecuniary gain to
22 such defendant as a result of the violation" for natural persons if
23 the violation "involved fraud, deceit, manipulation, or deliberate or
24 reckless disregard of a regulatory requirement" and "such violation
25 directly or indirectly resulted in substantial losses or created a
26
27
28

¹ At oral argument, the SEC did not oppose this resolution.

1 significant risk of substantial losses to other persons." 15 U.S.C. §
2 78u(d)(3)(B)(iii). Under the Code of Federal Regulations, the maximum
3 penalty was adjusted for inflation, and the maximum third tier penalty
4 is now \$120,000 for natural persons. 17 C.F.R. § 201.1002, Table II.

5 Similarly, the Advisers Act provides that "[w]hensoever it shall
6 appear to the Commission that any person has violated any provision of
7 this subchapter, . . . the Commission may bring an action in a United
8 States district court, and the court shall have jurisdiction to
9 impose, upon a proper showing, a civil penalty to be paid by the
10 person who committed such violation." 15 U.S.C. § 80b-9(e)(1). The
11 Advisers Act goes on to set forth three tiers of penalties identical
12 to the three tiers set forth in the Exchange Act. See 15 U.S.C. §
13 80b-9(e)(2)(A)-(C).

14 "District courts have discretion in determining the appropriate
15 amount" of such civil penalties. S.E.C. v. Lybrand, 281 F. Supp. 2d
16 726, 729 (S.D.N.Y. 2003). The Southern District of New York has set
17 forth the factors to be used for determining the proper level of such
18 penalties as follows:

19 (1) the egregiousness of the violations at issue; (2) defendants'
20 scienter; (3) the repeated nature of the violations; (4)
21 defendants' failure to admit their wrongdoing; (5) whether
22 defendants' conduct created substantial losses or the risk of
23 substantial losses to other persons; (6) defendants' lack of
24 cooperation and honesty with authorities, if any; and (7) whether
25 the penalty that would otherwise be appropriate should be reduced
26 due to defendants' demonstrated current and future financial
27 condition.

28 Id. at 730 (citations omitted).

1 The SEC argues that the Court should impose the maximum third
2 tier penalty of \$120,000 on Herwick because "she violated the
3 antifraud provisions and defrauded investors over several years,"
4 "[s]he acted with the highest levels of scienter, and personally
5 profited from the scheme," and "investors suffered actual losses."
6 (Pl. Motion for Summary Judgment at 6). Based on Herwick's conduct as
7 alleged in the Complaint, and which the Judgment requires the Court to
8 deem as true for purposes of this Motion, it appears that Herwick's
9 violations of the securities laws were serious, committed with
10 scienter, and repeated over several years. In addition, the Judgment
11 states that Herwick does not admit or deny the allegations in the
12 Complaint, so Herwick has failed to admit her wrongdoing. Further,
13 Herwick's conduct caused losses to the clients of NFSI.

14 Herwick raises two arguments in opposition to the Court's
15 imposition of a third tier civil penalty. First, Herwick argues that
16 a third tier penalty would be inappropriate because she "was not
17 deliberately reckless." (Opp. at 5). However, besides finding little
18 support in the evidence, Herwick's argument misreads the requirement
19 of 15 U.S.C. § 78u(d)(3)(B)(ii), which requires "fraud, deceit,
20 manipulation, or deliberate or reckless disregard of a regulatory
21 requirement" in order to warrant a third tier penalty. (emphasis
22 added).

23 Second, Herwick argues that she cannot pay a civil penalty of
24 \$120,000. Despite providing no admissible evidence,² Herwick's

25
26 ² The body of Herwick's Opposition alleges that Herwick has
27 incurred certain debts. Attached to Herwick's Opposition is a
28 document entitled "United States Securities and Exchange
Commission Statement of Financial Condition of Terese E.
Herwick." The origin of this document is unclear, and it
reflects different levels of debt than those reflected in the

argument suggests that she is in a great deal of debt. Herwick alleges that she has incurred the following six items of debt: 1) Herwick obtained an equity line of credit on her townhome in the amount of \$97,500 on behalf of NFSI, which NFSI never repaid; 2) Herwick has been held personally responsible for NFSI's corporate line of credit with Bank of America in the amount of \$96,440, which Herwick personally guaranteed; 3) Herwick has been held personally responsible for NFSI's corporate line of credit with Bank One in the amount of \$55,337, which Herwick personally guaranteed; 4) Herwick has been held personally liable for a debt owed by NFSI to FNF Capital in the amount of \$74,556, which Herwick personally guaranteed; 5) Herwick refinanced her townhome, worth \$540,000, with a \$575,000 mortgage and used the proceeds to pay \$160,000 for NFSI's outstanding legal and operational fees; and 6) Herwick accessed personal credit lines in the amount of \$55,000 for NFSI operating expenses and legal fees.

Because it does not appear that Herwick possesses the current financial wherewithal to satisfy the full \$120,000 third-tier civil penalty, the Court exercises its discretion to impose a lesser civil penalty based on Herwick's current financial condition, and ORDERS Herwick to pay a \$60,000 civil penalty. However, the Court is also permitted to consider Herwick's "future financial condition." S.E.C. v. Lybrand, 281 F. Supp. 2d at 729. Although Herwick may not currently have the ability to pay the full \$120,000 penalty, Herwick

body of Herwick's Opposition. Herwick alleges that the levels of debt reflected in the document are out of date. In addition, several of the items of debt that Herwick alleges in the body of her Opposition are not reflected in the Statement of Financial Condition, but Herwick alleges that the records of these debts are located at NFSI, and Herwick does not have access to these records.

1 ran an investment fund for some years and possesses significant
2 financial acumen, so it is possible that Herwick may find herself in a
3 more favorable financial position in the future. The Court's
4 imposition of a \$60,000 civil penalty will be sufficient to address
5 Herwick's violations of law should such a circumstance arise.


6
7 **IV. CONCLUSION**

8 The SEC's Motion for Summary Judgment of Disgorgement and
9 Imposing a Civil Penalty against Terese Herwick [105] is GRANTED IN
10 PART as follows. Because the undisputed evidence establishes that
11 NFSI paid Herwick a salary in the amount of \$286,006.76 during the
12 period of January 1, 2000 through September 13, 2003, and because the
13 SEC has conceded to have the Court reduce the amount of Herwick's
14 disgorgement to reflect insurance commissions received by Herwick and
15 included in her NFSI salary, Herwick is ORDERED to disgorge her ill-
16 gotten gains in the amount of \$143,003.38. The Court DECLINES to add
17 prejudgment interest to this amount.

18 Further, although the undisputed facts establish that the Court
19 has the discretion to impose a third tier civil penalty of \$120,000 on
20 Herwick, the Court ORDERS Herwick to pay a civil penalty of \$60,000,
21 based on Herwick's ability to pay.

22
23 IT IS SO ORDERED.

24
25 DATED: 4/19/05

26 
STEPHEN V. WILSON
UNITED STATES DISTRICT JUDGE