IN THE UNITED STATES DISTRICT COURT

FOR THE DISTRICT OF ARIZONA

Securities and Exchange Commission, Plaintiff, vs. David L. McMillan, Defendant.	No. CV 06-951-PCT-SMM **ORDER**

Pending before the Court is Plaintiff Securities and Exchange Commission's ("Plaintiff") Motion for Default Judgment (Dkt. 62).

BACKGROUND

Plaintiff commenced this action on April 4, 2006 by filing a Complaint against David L. McMillan ("Defendant") (Dkt. 1). The Complaint alleges that Defendant employed three different schemes to defraud investors. As a result of this conduct, Plaintiff alleges Defendant violated multiple federal securities laws.

Defendant's first scheme took place between February 2002 and October 2005 (Dkt. 1 at ¶ 11). Defendant told investors that he was offering and selling an annuity issued by Transnation Title Insurance ("Transnation"), an Arizona title insurance company (Id. at ¶ 12). Transnation did not offer any such annuities or pay interest on any such investments (Id. at ¶ 14). Defendant also created and mailed fictitious account statements on Transnation letterhead to investors showing their investment in Transnation and the amount of interest

allegedly being earned (Id. at ¶ 18). Defendant did not use the funds he received from investors to purchase Transnation annuities but instead used them for personal expenses (Id. at ¶ 15).

Defendant's second scheme involved Riverside Associates LP ("Riverside") (Dkt. 1 at ¶ 25). Riverside needed a $200,000 loan to cover some costs of developing property located in Bullhead City, Arizona. (Id.). The president of Riverside was introduced to a local mortgage broker in Bullhead City, who told him that he and Defendant could locate five to seven people to make the loan (Id.). In March 1999, Defendant and the mortgage broker persuaded investors to make the $200,000 loan (Id. at ¶ 26). Following the distribution of Riverside's principal payments to the investors in 2001, Defendant told the investors that they could continue their investment in Riverside loan by depositing the principal checks into their own bank accounts and writing a new check to "Schooner Financial" for the same amount (Id. at ¶¶ 28-34). Defendant owned a credit union account in the name of Schooner Financial, and he deposited the investors' checks into that account (Id. at ¶ 32). Defendant did not transfer the funds to Riverside (Id.). Around August 2002, Defendant began paying purported interest to investors on their Riverside loan by issuing checks drawn from the Schooner Financial account (Id. at ¶ 40). Defendant was operating a Ponzi scheme by making purported interest payments to investors from funds he had received from other investors rather than payments from Riverside (Id. at ¶ 41).

Defendant's third scheme began in 1999 and lasted until October 2005 (Dkt. 1 at ¶ 47). Defendant told investors that they could earn an annual return of 10% to 12% by investing in "First Deed of Trust investments" (Id. at ¶¶ 47, 49). Defendant represented to investors that their money would be used to make loans to prominent home building companies or individuals in the Bullhead City, Arizona area, and their investments would be secured by first deeds of trust on specific lots (Id. at ¶¶ 48, 50). Based on this information from Defendant, at least twelve investors paid Defendant approximately $1,664,699 between 1999 and October 2005 (Id. at ¶¶ 51-52). Defendant used investors' money for unauthorized

purposes, including personal expenditures and to pay interest to other investors (Id. at ¶¶ 54-57).

Plaintiff served the complaint, summons, temporary restraining order, and other pleadings upon Defendant by delivering them to him personally on April 8, 2006 (Dkt. 5). Defendant never answered the complaint, nor has Defendant filed any other pleading in this matter. Plaintiff applied for entry of default on August 23, 2006 (Dkt. 15). Pursuant to Rule 55(a), the Clerk of Court entered default judgment against Defendant on August 29, 2006 (Dkt. 18). Plaintiff now moves the Court for judgment against Defendant (Dkt. 62).

STANDARD OF REVIEW

The district court may use its discretion when deciding whether to enter default judgment. Aldabe v. Aldabe, 616 F.2d 1089, 1092 (9th Cir. 1980). Seven factors are generally considered before entering default judgment: "(1) the possibility of prejudice to the plaintiff, (2) the merits of plaintiff's substantive claims, (3) the sufficiency of the complaint, (4) the sum of money in the action; (5) the possibility of a dispute concerning material facts; (6) whether the default was due to excusable neglect, and (7) the strong policy . . . favoring decision on the merits." Eitel v. McCool, 782 F.2d 1470, 1471-72 (9th Cir. 1986).

"An allegation – other than one relating to the amount of damages – is admitted if a responsive pleading is required and the allegation is not denied." Fed. R. Civ. P. 8(b)(6). Thus, "[t]he general rule of law is that upon default the factual allegations of the complaint, except those relating to the amount of damages, will be taken as true." Geddes v. United Fin. Group, 559 F.2d 557, 560 (9th Cir. 1977); see Pope v. United States, 323 U.S. 1, 12 (1944). "Further support for the rule can be found in Federal Rule of Civil Procedure 55(b), which expressly authorizes the court to conduct a hearing on the issue of damages before entering a judgment by default." Geddes 559 F.2d at 560.

DISCUSSION

Although default judgments are generally disfavored, Defendant received notice of the Complaint more than three years ago and has not filed an answer or any other pleading

in this case. Under the first factor, Plaintiff is charged with enforcing the federal securities laws, and it would suffer great prejudice if it is unable to enforce them because a defendant refuses to defend an action. Moreover, Defendant may violate the securities laws again, and Plaintiff will be prejudiced if it cannot receive a judgment that enjoins and deters Defendant from committing another violation. With regard to factor two, the merits of Plaintiff's substantive claims are made clear in the Complaint. Through three different financial schemes, Defendant violated sections 206(1) and 206(2) of the Advisers Act, sections 17(a)(1), 17(a)(2) and 17(a)(3) of the Securities Act, and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. Plaintiff's complaint sufficiently demarcates Defendant's illegal conduct and the corresponding federal securities law violations, which satisfies factor three. Because Defendant has failed to answer, factors five and six are not an issue as there is no dispute concerning material facts in the case, nor was default due to excusable neglect. Factor seven, favoring a decision on the merits, is outweighed by the fact that this case is more than three years outstanding and Defendant has never disputed the allegations. The sum of money at stake, factor four, is discussed in the sections concerning disgorgement, prejudgment interest and civil penalties.

Because the allegations are taken as true, the facts established by the default support the causes of action pled in the Complaint. The Complaint also supports the finding that Plaintiff is entitled to the relief requested in the Motion for Default Judgment, which does not differ in kind from the relief requested in the Complaint. Henry v. Sneiders, 490 F.2d 315, 317 & n.2 (9th Cir. 1974). Accordingly, entry of default judgment is proper.

Plaintiff requests three forms of relief in the Complaint: (1) a permanent injunction restraining and enjoining the Defendant from violating securities laws, (2) disgorgement of all ill-gotten gains received or benefits in any form derived from the illegal conduct alleged in the Complaint, together with pre-judgment and post-judgment interest, and (3) third-tier civil penalties pursuant to Section 20(d)(2) of the Securities Act, Section 21(d)(3) of the Exchange Act and Section 209(e) of the Advisers Act.

I. Permanent Injunction

A. Availability of Injunction under Federal Law

Section 20(b) of the 1933 Securities Act, Section 21(d) of the 1934 Exchange Act, and Section 209(d) of the 1940 Advisers Act grant this Court discretion to enter a permanent injunction against any person who is engaged in or who is about to engage in actions that violate securities laws. 15 U.S.C. §§ 77t(b), 78u(d), 80b-9(d) (2002).

B. Ninth Circuit Factors for Permanent Injunction

In order to obtain a permanent injunction, Plaintiff must show that Defendant previously violated the securities laws and that there is a reasonable likelihood that Defendant would violate the securities laws in the future. SEC v. Murphy, 626 F.2d 633, 655 (9th Cir. 1980); SEC v. Poirier, 140 F. Supp. 2d 1033, 1046 (D. Ariz. 2001). "In order to assess the likelihood of future violations, the Court must evaluate the totality of the circumstances surrounding the violations, including: the degree of scienter involved; the isolated or recurrent nature of the violation; the defendant's recognition of the wrongfulness of the conduct; the likelihood, given the defendant's professional occupation, of future violations; and the sincerity of his assurances against future violations." Poirier 140 F. Supp. 2d at 1046 (citing Murphy, 626 F.2d at 655). Past violations may give rise to an inference that there will be future violations; and the fact that the defendant is currently obeying securities laws does not preclude an injunction. Murphy, 626 F.2d at 655.

In the present proceeding, the totality of the circumstances strongly suggests the need for an injunction. Defendant repeatedly violated federal securities laws beginning in 1999 and lasting until 2005, thus the violations were not isolated events. Defendant acted with a high degree of scienter in keeping multiple investment schemes open over a period of years, which included the creation of fictitious financial statements and the use of investor money for personal expenses. Defendant worked as an investment advisor and stock broker, and he may re-enter the securities industry. Defendant failed to answer the Complaint, nor did Defendant acknowledge his wrongful conduct or make any assurances against future

violations. Given the egregious nature of Defendant's violation of securities laws that occurred over many years, together with Defendant's scienter, profession, and failure to appear, injunctive relief is appropriate. Therefore, the Court concludes that Defendant should be permanently enjoined from future violations of 206(1) and 206(2) of the Advisers Act, sections 17(a)(1), 17(a)(2) and 17(a)(3) of the Securities Act, and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

II. Disgorgement of Ill-gotten Gains, including prejudgment interest and civil monetary penalties

A. Disgorgement and Prejudgment Interest

The district court has broad equity powers to order disgorgement of ill-gotten gains and prejudgment interest. SEC v. First Pac. Bancorp, 142 F.3d 1186, 1191 (9th Cir. 1998). Disgorgement is designed to deprive a wrongdoer of unjust enrichment. Hateley v. SEC, 8 F.3d 653, 655 (9th Cir. 1993). Disgorgement is also used to deter others from violating securities laws by making such conduct unprofitable. SEC v. Rind, 991 F.2d 1486, 1491 (9th Cir. 1993). To determine the appropriate disgorgement amount, the SEC need only show "a *reasonable approximation* of profits causally connected to the violation." First Pac. Bancorp, 142 F.3d at 1192 n.6 (emphasis added).

"Interest shall be allowed on any money judgment in a civil case recovered in a district court." 28 U.S.C. § 1961 (2000); see SEC v. CMKM Diamonds, 635 F. Supp. 2d 1185, 1190 (D. Nev. 2009) (citing SEC v. Cross Fin. Servs., Inc., 908 F. Supp 718, 734 (C.D. Cal. 1995)). Prejudgment interest is included with disgorgement to prohibit a defendant from gaining profits on what would otherwise amount to an interest free loan. CMKM Diamonds, 635 F. Supp. 2d at 1190; see SEC v. Moran, 944 F. Supp. 286, 295 (S.D.N.Y. 1996). Although prejudgment interest may be calculated at the post-judgment rate specified in 28 U.S.C. § 1961, when the SEC itself orders disgorgement, it generally imposes the Internal Revenue Service ("IRS") underpayment rate under IRC § 6621(a)(2). See, e.g., 17 C.F.R. § 201.600. "That rate reflects what it would have cost to borrow the money from the

government and therefore reasonably approximates one of the benefits the defendant derived from its fraud." SEC v. First Jersey Sec., Inc., 101 F.3d 1450, 1476 (2d Cir. 1996). Accordingly, courts routinely approve the use of the IRS underpayment rate in connection with disgorgement. See SEC v. Drexel Burnham Lambert Inc., 837 F. Supp. 587, 612 n. 8 (S.D.N.Y. 1993) (citations omitted), aff'd, 16 F.3d 520 (2d Cir. 1994), cert. denied, 513 U.S. 1077 (1995); see also Poirier, 140 F. Supp. 2d at 1047.

Plaintiff calculated the disgorgement amount by adding the money received from investors and subtracting subsequent withdrawals made by investors (Dkt. 63, Ex. A). In sum, Defendant received $2,430,874.15 in ill-gotten gains during the period beginning February 1999 through October 2005 (Id.). The Commission recovered $413,779.65 from Defendant through the sale of Defendant's residence (Dkt. 34) and by recovering a check that was intended for Defendant (Dkt. 44). At present, $2,017,094.50 of Defendant's ill-gotten gains remains outstanding (Dkt. 63, Ex. A). Because Plaintiff presents a reasonable approximation of profits causally connected to Defendant's securities laws violations, disgorgement in the amount of $2,017,094.50 is proper.

Plaintiff also requests prejudgment interest in the amount of $565,234.02 (Dkt. 63, Ex. A). Plaintiff calculates this amount by applying the IRS underpayment rate determined by IRC § 6621(a)(2) to Defendant's outstanding ill-gotten gains ($2,017,094.50) beginning November 1, 2005 and ending June 30, 2009. Although the post-judgment rate specified in 28 U.S.C. § 1961(a) may apply to certain securities laws violations, the IRS underpayment rate is appropriately utilized here due to the ongoing and recurrent nature of Defendant's violations, Defendant's high degree of scienter, and the substantial loss suffered by investors. See 28 U.S.C. § 1961. Furthermore, because the calculation of prejudgment interest begins in November 2005 and is based only on the amount of disgorgement that is still outstanding, rather than the entire amount of ill-gotten gains, the amount of prejudgment interest requested by Plaintiff is reasonable. Finally, the total amount of prejudgment interest in the present case shall be calculated from November 2005 to include the most recent and

complete fiscal quarter before the entry of this judgment. Therefore, the total amount of prejudgment interest owed by Defendant is $591,113.97.

B. Civil Monetary Penalty

The court has broad discretion in setting the civil penalty. See CMKM Diamonds, 635 F. Supp. 2d at 1193 (citing SEC v. Yuen, 272 Fed. Appx. 615, 618 (9th Cir. 2008)). The Securities Act assesses civil penalties according to a three-tier system. 15 U.S.C. §77t(d). Third-tier penalties are imposed for violations that involve (1) "fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement;" and (2) "directly or indirectly resulted in substantial losses or created a significant risk of substantial losses to other persons." 15 U.S.C. § 77t(d)(2)(c). Section 20(d) of the Securities Act, Section 21(d)(3) of the Exchange Act, and Section 209(e) of the Advisers Act state that the amount of such a penalty shall be determined by the Court "in light of the facts and circumstances." 15 U.S.C. §§ 77t(d), 78u(d), 80(b)-9(e). Courts have calculated third-tier civil penalties in two ways: a court may impose a flat penalty for each violation, or a court may impose a penalty equal to the gross amount of pecuniary gain as a result of the violation. 15 USC § 77t(d)(2); see SEC v. Coates, 137 F. Supp. 2d 413, 430 (S.D.N.Y. 2001); SEC v. Solow, 554 F. Supp. 2d 1356, 1368 (S.D. Fla. 2008). Here, Plaintiff requests a flat penalty in the amount of $120,000 (Dkt. 62).

In this case, the Court will order a third-tier penalty because Defendant's conduct meets the two statutory requirements. In regard to the first requirement, Defendant's financial schemes were fraudulent, deceitful, and manipulative. Defendant ran a Ponzi scheme, sold annuities that did not exist, and provided fictitious financial statements to investors while using investor money for personal expenses. Moreover, Defendant's violations involving fraud and deceit were numerous and ongoing. Additionally, the boldness of the fraud demonstrates Defendant's high level of scienter. Thus, Defendant's conduct satisfies the first statutory requirement. Concerning the second requirement, Defendant's conduct caused

losses to victims in excess of $2,000,000. As Defendant's conduct resulted in direct and substantial losses, Defendant's conduct satisfies the second requirement.

Under 15 U.S.C. § 77t(d)(2), the Court may charge Defendant with a flat penalty per violation or a penalty equal to Defendant's gross pecuniary gain. Using the second method specified by the statute, the penalty imposed on Defendant would be over $2,000,000. However, Plaintiff only requests the maximum flat penalty under the first method for a third-tier violation. The current maximum penalty for third-tier violations committed by natural persons that result in substantial and direct losses is $150,000. 17 C.F.R. § 201.1004. However, the maximum third-tier penalty for violations prior to February 14, 2005 is $120,000. 17 C.F.R. §201.1003.[1] Increased penalties apply only to violations that occur after the increase takes place. Id. Because the majority of Defendant's violations took place prior to February 14, 2005, the appropriate maximum civil monetary penalty per violation is $120,000. Although the Court could elect to fine Defendant the maximum third-tier penalty for each individual securities laws violation, thereby multiplying the penalty, Plaintiff requests only a one-time penalty of $120,000 under the first method. Moreover, as noted, Plaintiff does not request a penalty equal to Defendant's gross pecuniary gain under the second method. Thus, the Court finds proper and imposes a third-tier civil monetary penalty in the amount of $120,000 on Defendant.

Accordingly,

IT IS HEREBY ORDERED that Plaintiff's Motion for Default Judgment (Dkt. 62) is **GRANTED**.

IT IS FURTHER ORDERED that the Clerk of Court shall enter Default Judgment against Defendant and in favor of Plaintiff.

IT IS FURTHER ORDERED that Defendant is permanently restrained and enjoined from violating Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act")

[1] The Debt Collection Improvement Act of 1996 requires that each Federal agency adopt regulations at least once every four years that adjust for inflation the maximum amount of the civil monetary penalties allowed under the statutes administered by the agency. SEC Rules & Regulations, 70 Fed. Reg. 7606 (Feb. 14, 2005).

[15 U.S.C. § 78j(b)] and Rule 10b-5 promulgated thereunder [17 C.F.R. § 240.10b-5], by, directly or indirectly, using any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange, in connection with the purchase or sale of any security:

(a) to employ any device, scheme, or artifice to defraud;

(b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; or

(c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

IT IS FURTHER ORDERED that Defendant is permanently restrained and enjoined from violating Section 17(a) of the Securities Act of 1933 (the "Securities Act") [15 U.S.C. § 77q(a)] in the offer or sale of any security by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly:

(a) to employ any device, scheme, or artifice to defraud;

(b) to obtain money or property by means of any untrue statement of a material fact or any omission of a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or

(c) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

IT IS FURTHER ORDERED that Defendant is permanently restrained and enjoined from violating, Sections 206 (1) and (2) of the Investment Advisers Act of 1940 [15 U.S.C. § 80b-6(1) and (2)] (the "Investment Advisers Act"), in connection with his business as an investment advisor, by use of the mails or means or instrumentalities of interstate commerce, directly or indirectly, to employ devices, schemes or artifices to defraud clients and

prospective clients; or to engage in transactions, practices or courses of business which have operated, are operating and will operate as a fraud or deceit upon clients or prospective clients.

IT IS FURTHER ORDERED that Defendant is liable for disgorgement of $2,017,094.50, representing ill-gotten profits gained as a result of the conduct alleged in the Complaint, less the amount that has been collected by the plaintiff from the Defendant to date, together with prejudgment interest thereon in the amount of $591,113.97, and a civil penalty of $120,000 pursuant to Section 20(d) of the Securities Act, Section 21(d) of the Exchange Act and Section 209(e) of the Advisers Act.

Defendant shall satisfy this obligation by paying **$2,728,208.47** within ten (10) business days after entry of this Default Judgment by certified check, bank cashier's check, or United States postal money order payable to the to the Clerk of this Court, together with a cover letter identifying David L. McMillan's as a defendant in this action; setting forth the title and civil action number of this action and the name of this Court; and specifying that payment is made pursuant to this Final Default Judgment. Defendant shall simultaneously transmit photocopies of such payment and letter to the Commission's counsel in this action. By making this payment, Defendant relinquishes all legal and equitable right, title, and interest in such funds, and no part of the funds shall be returned to Defendant. Defendant shall pay postjudgment interest on any delinquent amounts pursuant to 28 USC § 1961.

The Clerk shall deposit the funds into the previously established "fair fund" in this matter also know as Subaccount 3. These funds, together with any interest and income earned thereon shall be held until further order of the Court. The Commission may by motion propose a plan to distribute the Fund subject to the Court's approval.

Amounts ordered to be paid as civil penalties pursuant to this Judgment shall be treated as penalties paid to the government for all purposes, including all tax purposes. To preserve the deterrent effect of the civil penalty, Defendant shall not, after offset or reduction of any award of compensatory damages in any Related Investor Action based on Defendant's

payment of disgorgement in this action, argue that he is entitled to, nor shall he further benefit by, offset or reduction of such compensatory damages award by the amount of any part of Defendant's payment of a civil penalty in this action ("Penalty Offset"). If the court in any Related Investor Action grants such a Penalty Offset, Defendant shall, within 30 days after entry of a final order granting the Penalty Offset, notify the Commission's counsel in this action and pay the amount of the Penalty Offset to the United States Treasury or to a Fair Fund, as the Commission directs. Such a payment shall not be deemed an additional civil penalty and shall not be deemed to change the amount of the civil penalty imposed in this Judgment. For purposes of this paragraph, a "Related Investor Action" means a private damages action brought against Defendant by or on behalf of one or more investors based on substantially the same facts as alleged in the Complaint in this action.

IT IS FURTHER ORDERED that this Court shall retain jurisdiction of this matter for the purposes of enforcing the terms of this Default Judgment.

DATED this 19th day of October, 2009.

Stephen M. McNamee
United States District Judge