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Proposed Counsel for the Official Committee of Unsecured Creditors in the Bankruptcy Cases

UNITED STATES DISTRICT COURT

DISTRICT OF NEVADA

SECURITIES AND EXCHANGE COMMISSION, Plaintiff, vs. MATTHEW WADE BEASLEY, *et al*., Defendants, THE JUDD IRREVOCABLE TRUST, *et al*., Relief Defendants,	Case No. 2:22-cv-00612-CDS-EJY **RESPONSE OF THE OFFICIAL COMMITTEE OF UNSECURED CREDITORS TO RECEIVER'S REPORT AND RECOMMENDATION REGARDING CHAPTER 11 CASES** **Hearing Date: July 25, 2022** **Hearing Time: 10:00 a.m.** **Hearing Location: In Person or Zoom** **Lloyd D. George Courthouse** **333 Las Vegas Blvd. S.** **Las Vegas, NV 89101**

The Committee (defined below) submits the following response to the *Receiver's Report and Recommendation Regarding Chapter 11 Cases* [ECF No. 127] (the "Report").

I. PRELIMINARY STATEMENT

On June 1, 2022, the Office of the United States Trustee[1] appointed an official committee of unsecured creditors (the "Committee") in the chapter 11 bankruptcy cases of defendants *J & J Consulting Services, Inc.* and *J and J Purchasing LLC* (together, the "Debtors").

The Committee's duty is to protect the interests of unsecured creditors in the bankruptcy cases. Those unsecured creditors are primarily comprised of the hundreds (and potentially in excess of 1,000) victims of the fraud detailed in the complaint initiating the above-captioned action.

Within 48 hours of its appointment, the Committee interviewed and retained counsel to represent it in connection with the bankruptcy cases. It was during the interview process that the Committee learned of the entry of the *Order Appointing Receiver* [ECF No. 88] (the "Appointment Order"). Because that order provided for a broad stay of the bankruptcy cases (see ¶¶ 32-33), the Committee took no substantive action while it awaited the filing of the Report.

The Committee is not like any other party to this action. The Committee acts on behalf of, and owes fiduciary duties to, all of the unsecured creditors and victims of the Debtors. As a fiduciary, the Committee is held to the highest of standards and is required to be honest, loyal, trustworthy and without conflicts of interest. It is from this perspective (*i.e.* that of a fiduciary) that the Committee files this response (the "Response") to the Report.

This Response is not an attack on the Appointment Order or a criticism of the Report itself. The Committee does, however, disagree with the Receiver's recommendation and the conclusions drawn in the Report. As a result, and to fulfill its

[1] The United States Trustee operates as a component of the Department of Justice that works to protect the integrity of the bankruptcy system by overseeing bankruptcy case administration. Its mission is to promote the integrity and efficiency of the bankruptcy system for the benefit of all stakeholders.

statutory obligations, the Committee files this Response to highlight for the Court the Committee's concerns should the bankruptcy cases be dismissed, which in summary are:

- though no doubt an unintended consequence, dismissal of the bankruptcy cases would silence the victims in a devastating manner;
- the victims in these cases specifically opted to proceed via bankruptcy by filing involuntary bankruptcy cases (as opposed to seeking the appointment of a receiver);
- on multiple critical levels, the receivership framework is an inadequate substitute for the bankruptcy process and the robust statutory framework of title 11 of the United States Code (the "Bankruptcy Code");
- the Report's recommendation to simply withdraw the reference of the bankruptcy cases in their entirety and dismiss them *sua sponte* robs the unsecured creditors of due process with respect to the opportunity to be heard; and
- the bankruptcy cases can continue with the Receiver acting on behalf of the Debtors while working in concert with the Committee.

Assuming the bankruptcy cases remain in place, the Committee requests that the Court set a further status conference in this action within a few weeks to allow the Receiver and the Committee to meet and confer regarding the logistics of proceeding with the bankruptcy cases. It is the Committee's hope that the Receiver and the Committee can provide a joint report and recommendation to this Court in advance of such status conference.

II. DISCUSSION

A. Dismissal of the Bankruptcy Cases Will Unfortunately Silence the Victims.

As an initial matter, the Committee—unlike the Receiver—acts on behalf of, and owes fiduciary duties to the victims and other unsecured creditors of the Debtors. *See In re Farrell*, 610 B.R. 317, 322 (Bankr. C.D. Cal. 2019) ("A member of a creditors' committee has a fiduciary duty to all creditors they represent."); *In re Rickel & Assocs., Inc.*, 272 B.R. 74, 99 (Bankr. S.D.N.Y. 2002) ("The Committee and its members owed a fiduciary duty to the class they represented, but not to the individual creditors within the class or to the estate.").

If this Court were to dismiss the bankruptcy cases it would result in the immediate and automatic dissolution of the Committee, which would in turn effectively rob the vast majority of victims of any meaningful opportunity to participate in any action against the defendants or have a say in their recoveries.

Without the Committee, the victims and other unsecured creditors of the Debtors will be forced to hire their own counsel—likely a cost prohibitive proposition for many of the victims. Even if some of them ultimately retain their own counsel, their access to information will be severely limited as they remain on the outside looking in. Counsel for individual creditors will be empowered to do little more than observe and report because the victims themselves are not parties to this action. Indeed, their standing to do anything is extremely limited. They are at the complete mercy of the Receiver and, while the Receiver no doubt will be working to achieve a favorable outcome, he is not doing so with the victims in mind in the same way the Committee would because the Receiver does not owe his duties solely to the victims as the Committee does.

Official committees of unsecured creditors are designed to address these exact collective action problems specific to disparate groups of similarly situated creditors. Here, in carrying out its statutory role, the Committee serves as a check on the Debtors (now controlled by the Receiver) and acts as a critical voice for the unsecured creditor body.

The creditors in the bankruptcy cases were robbed a first time when they fell victim to a massive fraud. The filing of the bankruptcy cases and the appointment of the Committee empowered creditors. Dismissing the bankruptcy cases and dissolving the Committee would risk unnecessarily robbing these creditors for a second time.

B. The Victims of this Fraud Organized and Made an Informed Decision to Commence Bankruptcy Cases.

Dismissal of the bankruptcy cases will deprive the victims that commenced the bankruptcy cases of their chosen forum (*i.e.*, the bankruptcy court). Specifically, certain victims intentionally opted into the bankruptcy process by commencing involuntary

bankruptcy cases under section 303 of the Bankruptcy Code *months* before the appointment of the Receiver.

Congress specifically drafted section 303 to provide creditors with a unilateral remedy to compel liquidation or reorganization of a debtor's estate under the purview of the rights and protections offered under the Bankruptcy Code. Indeed, "[t]he central policy behind involuntary petitions was to protect the threatened depletion of assets or to prevent the unequal treatment of similarly situated creditors." *In re Manhattan Industs., Inc.*, 224 B.R. 195, 200 (Bankr. M.D. Fla. 1997); *see also In re Marcano*, 708 F.3d 1123, 1129 (9th Cir. 2013). Whenever there is threatened depletion of assets or unequal treatment of similarly situated creditors, bankruptcy policy dictates that a creditor be able to compel liquidation or reorganization of debtor's estate through the filing of an involuntary bankruptcy petition. *Manhattan*, 708 F.3d at 1129.

The chapter 11 process was specifically chosen by the victims because of the complexity of the circumstances at issue, including the number of claims, the value of the claims, the fraudulent conduct of the Debtors, and (in the absence of the automatic stay) the pending civil litigation across the country against the Debtors. Their decision should be respected.

C. Receivership is an Inadequate Substitute for the Bankruptcy Cases Given the Complex Circumstances at Issue.

Courts have held that a receivership is not an adequate substitute for a traditional bankruptcy case including in circumstances that, like here, involve securities fraud violations. *See e.g., Eberhard v. Marcu*, 530 F.3d 122, 132 (2d Cir. 2008) ("[B]ecause receivership should not be used as an alternative to bankruptcy, we have disapproved of district courts using receivership as a means to process claim forms and set priorities among various classes of creditors."); *SEC v. Am. Bd. Of Trade, Inc.*, 830 F.2d 431, 437 (2d Cir. 1987) ("The functions undertaken by the district court in this case demonstrate the wisdom of not using a receivership as a substitute for bankruptcy… [T]he court has taken upon itself the burden of processing proof-of-claim forms filed by thousands of [investors]

and other creditors, of setting priorities among classes of creditors, and of administering sales of real property, all without the aid of either the experience of a bankruptcy judge or the guidance of the bankruptcy code."); *Los Angeles Trust & Mortg. Exchange v. SEC*, 285 F.2d 162, 182 (9th Cir. 1961) ("The trial court has found insolvency in the bankruptcy sense, but there is no apparent reason here why the violation of the Securities Act and the Securities Exchange Act should lead to a different type of final liquidation than that which is had for the normal corporate bankrupt. In true bankruptcy, procedures are better geared for creditors and depositors to give them a day in court and protect their rights.").

1. When it comes to maximizing value, the liquidation of assets pursuant to section 363 of the Bankruptcy Code has no equal.

Bankruptcy provides a statutory framework that specifically allows a chapter 11 debtor to sell its assets "free and clear" of liens, claims, and other interests, including most successor liability claims, under section 363 of the Bankruptcy Code and a massive body of associated case law. *See* 11 U.S.C. § 363(f).

Although a District Court can enter an order approving a "free and clear" sale, would-be buyers may be less comfortable participating in any sale that is not predicated upon the large body of developed case law and the clear statutory framework associated with a sale under section 363.

In addition, the benefits to "363 sales" extend far beyond the mere ability to effect a sale "free and clear." For instance, subsection (m) of section 363 allows a good faith purchaser to buy assets with the comfort that even if a bankruptcy court's order approving a sale is reversed on appeal, the underlying sale itself will not be unwound. This protection incentivizes potential asset purchasers to submit bids, thereby facilitating a value-maximizing sale in a way that other court-supervised sale processes cannot.

2. There is no analogue to a chapter 11 plan in a receivership.

A chapter 11 plan of reorganization or liquidation provides for, among other things, the equitable distribution of value to a chapter 11 debtor's creditors and equity holders pursuant to section 1129 of the Bankruptcy Code. *See* 11 U.S.C. § 1129.

All parties-in-interest in the bankruptcy case (meaning all creditors) receive notice of the proposed chapter 11 plan and those creditors and equity holders who will receive a distribution of value under the chapter 11 plan in an amount less than the full amount of their claim are entitled to vote to accept or reject the plan. *See* 11 U.S.C. § 1126(a).

Once confirmed after notice and a hearing, the chapter 11 plan is binding and has the effect of a judgment on all parties that received notice of it. *See* 11 U.S.C. § 1141(a). In short, the chapter 11 plan process, which is not available in District Court, is a comprehensive tool to facilitate the equitable distribution of value to creditors in a way that is consistent with due process and provides finality and certainty in a way that is simply unavailable in a receivership.

3. Turning this Court into a de facto Bankruptcy Court, but without the benefit of the Bankruptcy Code, is an unnatural and forced solution.

While the Report suggests that the Receiver can seek injunctive relief to provide for the same relief that parties-in-interest could obtain in the bankruptcy cases, that is not a practical solution and, to the contrary, highlights the need for the tools embedded in the Bankruptcy Code. Specifically, even if the Receiver could obtain bankruptcy-like relief as part of the receivership, this Court will have to fashion that relief without the benefit of the entire statutory framework offered by the Bankruptcy Code and the nearly 40 years of associated case law upon which bankruptcy courts rely in exercising their equitable power over the bankruptcy process.

It is overly simplistic to suggest, as the Report does, that the bankruptcy cases are unnecessary. Courts have found good reasons exist to allow a bankruptcy case to proceed notwithstanding a parallel receivership. *See SEC v. Lincoln Thrift Ass'n*, 577 F.2d 600, 605–06 (9th Cir. 1978).[2] In fact, the bankruptcy process is uniquely designed for complex

[2] "Perhaps the most relevant reason is that the Bankruptcy Act allows the formation of a creditors' committee. . . . The Bankruptcy Act also provides for notice to the creditors or their committee of all sales of property and provides the opportunity for a hearing on the issue of whether a sale should be had. In addition, the Bankruptcy Act provides an established system for equitable distribution of the assets to creditors."

circumstances such as these in which there are hundreds of creditors, numerous causes of action against debtor entities, and the need to develop an equitable plan to distribute value to victims and other unsecured creditors.

Dismissal of the bankruptcy cases would effectively force this Court to develop a bankruptcy-like, makeshift process to, among many other things: (i) manage victims' proofs of claim (of which there may be hundreds), including maintaining a database akin to the claims register that is currently already managed by a third party claims agent; (ii) stay adverse creditor collection actions or otherwise specially allow some but not all causes of action to go forward in disparate jurisdictions;[3] (iii) develop an equitable plan to distribute value to Victims;[4] and (iv) oversee the actual distribution of value once a plan to do so has been finalized.

The alternative, of course, is to simply allow the bankruptcy cases to proceed with the comfort that the Bankruptcy Code and the bankruptcy court interpreting it are well equipped to address all of these issues in one forum with relative ease, since that is what they are specifically intended to do.

Unlike a bankruptcy case, a receivership is not intended to serve as the mechanism to distribute value to creditors. *See, e.g., Kokesh v. SEC*, 137 S. Ct. 1635, 1644 (2017) ("Some disgorged funds are paid to victims; other funds are dispersed to the United States Treasury… the primary function of depriving wrongdoers of profits is to deny them the fruits of their ill-gotten gains, not to return the funds to victims as a kind of restitution").

There is good reason for this well-established case law and favoritism of the bankruptcy system under circumstances similar to those at hand. The chapter 11

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[3] As highlighted in the Report, there are at least five adversary proceedings pending as part of the bankruptcy cases that would be eliminated if the bankruptcy cases are dismissed. There is also the possibility that fraudulent transfer and preference-like actions may need to be commenced in the future. Preference actions would be unavailable outside of bankruptcy.

[4] It is worth noting that although it is likely that victims make up the vast majority of unsecured claims against the Debtors, there are likely some holders of general unsecured trade claims against the Debtors that are not party to these proceedings and may fail to receive any recovery if there is no value left after paying victims.

bankruptcy process—when it is permitted to proceed—provides a host of advantages that are not available in a receivership. A few examples highlight these advantages.

If the bankruptcy cases are dismissed, this Court will be left to recreate large swaths of the Bankruptcy Code through a patchwork of orders and rulings. The Appointment Order, which already numbers 20 pages, is just the beginning; developing a paradigm similar to bankruptcy will be a significant tax on this Court's time and resources and will, undoubtedly, slow the efficient resolution of the issues in these proceedings. It makes little sense to rebuild in this Court an entire system that is ready-made and designed for this specific purpose in the bankruptcy court.

4. The Bankruptcy Court provides a single venue specifically designed for, and capable of administering assets on behalf of, multiple entities for the benefit of multiple creditors.

It does not matter that some potential wrongdoers are not debtors in the bankruptcy cases as there are a variety of methods to draw the wrongdoers and their assets into the bankruptcy cases. In fact, the Appointment Order already contemplates this by empowering the Receiver to commence additional bankruptcy cases on behalf of other entities. *See* Appointment Order, ¶ 48. But that is not the only tool available to ensure that complete relief is available in bankruptcy court. As an alternative, the Receiver, the Committee, or another party-in-interest in the bankruptcy cases could seek to substantively consolidate the Debtors' assets with that of certain non-Debtor defendants[5] or file additional adversary proceedings in the bankruptcy cases[6] to bring in new parties if the Receiver determines that it he is unable or unwilling to commence additional bankruptcy cases.

In short, there are options to address the fact that not all defendants and wrongdoers are part of the bankruptcy cases without foregoing all of the advantages that bankruptcy provides.

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[5] *See In re Bonham*, 229 F.3d 750 (9th Cir. 2000) (Substantive consolidation of debtor and non-debtor entities arising from Ponzi scheme).

[6] *See* Fed. R. Bankr. P. 7001.

D. The Receiver's Recommendation that this Court Dismiss the Bankruptcy Cases *Sua Sponte* Raises Due Process Concerns.

The Receiver suggests this Court withdraw its reference and dismiss the bankruptcy cases. *See* Receiver's Report, ¶ I. That recommendation raises concerns regarding the absence of due process that would otherwise be afforded to creditors (including the victims) in connection with the statutory framework ordinarily associated with dismissal of bankruptcy cases.

Withdrawal of a bankruptcy case is an extreme measure, and when taken in rare circumstances, is often just as to a portion of a bankruptcy case. *See 880 S. Rohlwing Road, LLC v. T&C Gymnastics, LLC*, 2017 WL 264504, at *8 (N.D. Ill. Jan. 19, 2017) ("As courts have recognized, 'a motion seeking a withdrawal of an entire bankruptcy case, as opposed to merely a proceeding within the case, is an extreme request'." (citations omitted)).

Here, the Receiver has made this extreme request without the benefit of a properly noticed motion. This in and of itself underscores the risk associated with having a single party—even a court-appointed independent receiver—empowered to do what he thinks is best with few checks or balances.

Ordinarily, dismissal of a chapter 11 case requires notice and a hearing and is only appropriate when there has been a showing of "cause." *See* 11 U.S.C. 1112(b). Further, the Bankruptcy Code explicitly takes into account whether dismissal is "in the best interests of creditors and the [bankruptcy] estate." *Id.* It is a concern that the Receiver is seeking bankruptcy-specific relief from this Court under the Bankruptcy Code, without the protections that Congress included in the statute in question.

E. If the Bankruptcy Cases are Allowed to Proceed, the Committee and the Receiver Would Work in Concert in Several Important Regards, all as Intended Under the Bankruptcy Code.

While the Committee disagrees with the recommendations and conclusions in the Report, the Committee views as constructive and beneficial the Receiver's appointment as decision-maker for the Debtors. If the bankruptcy cases are allowed to remain in place, the

Committee, in carrying out its fiduciary duty to creditors, will likely often find itself aligned with the Receiver. At the same time, it is critical that the victims and creditors have a voice of their own and the ability to provide a check and balance to the Receiver.

III. CONCLUSION

For the reasons discussed above the Committee requests that the Court (a) not adopt the Report *in toto*, (b) not withdraw the reference of the bankruptcy cases from the bankruptcy court, and (c) instead allow the bankruptcy cases to proceed with the Receiver at the helm of the Debtors and the Committee acting in its fiduciary capacity to carry out the important role Congress intended when it formulated the Bankruptcy Code.

Dated: July 18, 2022

/s/ Ori Katz
Ori Katz
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-and-

Louis M. Bubala III
KAEMPFER CROWELL

Proposed Counsel for the Official Committee of Unsecured Creditors in the Bankruptcy Cases

CERTIFICATE OF MAILING

I HEREBY CERTIFY that on the 18th day of July, 2022, I caused a copy of the foregoing to be filed with the Court via ECF which sent notice of such filing to all parties entitled to receive service through the Court's ECF system.

DATED this 18th day of July, 2022.

/s/ Louis M. Bubala III
Louis M. Bubala III