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UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF CALIFORNIA – SAN FRANCISCO

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| CONSOLIDATED MANAGEMENT GROUP, LLC, a Kansas limited liability company; CONSOLIDATED LEASING ANADARKO JOINT VENTURE, a Kansas general partnership; and CONSOLIDATED LEASING HUGOTON JOINT VENTURE #2, a Kansas general partnership,<br><br>Plaintiffs,<br>vs.<br><br>PRESTON DuFAUCHARD, California Corporations Commissioner; and CALIFORNIA DEPARTMENT OF CORPORATIONS.<br><br>Defendants. | Case No.: C 06-4203-JSW<br><br>MEMORANDUM OF POINTS AND AUTHORITIES IN SUPPORT OF REPLY TO PLAINTIFFS OPPOSITION TO MOTION TO DISMISS PURSUANT TO RULE 12(b)(6) FOR FAILURE TO STATE A CLAIM ON WHICH RELIEF CAN BE GRANTED<br><br>DATE: September 8, 2006<br>TIME: 9:00 a.m.<br>DEPT: Courtroom 2, 17th Floor<br>JUDGE: Hon. Jeffrey S. White<br><br>**FILED VIA E-FILING** |

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MEMORANDUM OF POINTS AND AUTHORITIES IN SUPPORT OF REPLY TO PLAINTIFFS' OPPOSITION TO MOTION TO DISMISS PURSUANT TO RULE 12(b)(6) FOR FAILURE TO STATE A CLAIM ON WHICH RELIEF CAN BE GRANTED

The defendants, PRESTON DuFAUCHARD, California Corporations Commissioner, and the California Department of Corporations (collectively, the "Department") submit the following Memorandum of Points and Authorities in support of their Reply to plaintiffs' opposition to Motion to Dismiss pursuant to Rule 12(b)(6).

A. STATEMENT OF THE ISSUES

Nowhere in their opposition to this motion or in their Complaint do the plaintiffs claim that their offers of securities in California complied with federal registration exemption restrictions, or specifically Regulation D, Rule 506, 17 C.F. R. section 230.506. The plaintiffs argue instead that whether or not they violated Regulation D, the Commissioner cannot issue an order concerning their non-exempt offerings as long as the plaintiffs have filed with the SEC and California notice forms that they were claiming such an exemption. The plaintiffs' argument is unreasonable and contrary to the express language of the applicable federal exemption and preemption statutes. The statute on which the plaintiffs predicate exemption from registration of their offering under California law, C.C. section 25102.1, permits a "notice filing" of a Regulation D exemption, but only if the security actually "is exempt" from registration pursuant to Regulation D. Without full compliance with Regulation D, plaintiffs cannot claim the federal or state exemptions from registration, nor can they claim they were offering a "covered security" entitled to NSMIA preemption. As long as the Complaint fails to allege the essential facts to demonstrate that plaintiffs' conduct met with all federal exemption requirements in connection with their offerings, the Complaint cannot state a claim under federal law and this action should be dismissed.

In addition, the plaintiffs seek the same relief from this Court that they sought through the administrative hearing they initiated. Plaintiffs have adequate remedies, which they have not exhausted, in the state court system. Accordingly, the Department requests an order of dismissal based on the federal abstention doctrine.

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B. LAW AND ARGUMENT.

1. PLAINTIFFS HAVE FAILED TO STATE FACTS THAT SUPPORT A CLAIM

The plaintiffs have failed to state facts that support a claim under federal law. Plaintiffs stress that motions under Federal Rule 12(b)(6) should not be granted on the basis of disputed facts or factual challenges outside the complaint. The Department agrees with this point. The Department bases its motion to dismiss on the facts alleged in the Complaint, and for purposes of this motion, assumes them to be true. As alleged, the Complaint fails to state facts upon which relief can be granted. The plaintiffs are claiming that all they have to allege is that they filed notices with the SEC and California that they would be offering securities in California that would be exempt from the private offering exemption Rules under Regulation D. As the Department has shown, until the Complaint alleges compliance with the provisions of Regulation D, the plaintiffs are not entitled to exemption protection under either federal or California law. Similarly, without those factual allegations, plaintiffs cannot assert the preemption protection provided by NSMIA for a "covered security" that "is exempt".

For further argument and legal authority showing the reason dismissal for failure to claim should be granted, the court is respectfully referred to argument number 6 entitled "Plaintiff has Failed to State a Claim under 42 USC 1983" at pages 12 to 14 of the Department's memorandum of points and authorities in support of this motion.

2. PLAINTIFFS FAILED TO EXHAUST THEIR STATE LAW REMEDIES, AND THE COURT SHOULD ABSTAIN FROM HEARING THIS ACTION, INSTEAD DISMISSING IT AS PREMATURE.

Plaintiffs inappropriately rely on a case that no longer accurately reflects Ninth Circuit abstention law, Champion v Brown, 731 F.2d 1406 (9th Cir. 1984). Two years after Champion the United States Supreme Court in Ohio Civil Rights Commission v Dayton, 477 U.S. 619 (1986) expanded the scope of abstention to cover state administrative proceedings. Moreover, the Supreme Court expressly criticized the narrow abstention approach used by the Ninth Circuit in Martori Brothers Distributors v James-Massengale 781 F.2d 1349 (9th Cir. 1986), a case that had relied upon Champion as authoritative. Following Dayton the Ninth Circuit had the opportunity to reconsider abstention and did indeed expand its scope in Fresh International v Agricultural Labor Relations Bd.,



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805 F.2d 1353, 1357, 1359 (9th Cir. 1986). As shown in the Department's moving papers, Fresh International found abstention in a case indistinguishable from this instant case in virtually every respect.

In their opposition plaintiffs argue, citing Champion, that one Commission order as opposed to a challenge of a whole administrative procedure is not a substantial enough interference to justify abstention. The plaintiffs do not disclose that the Fresh International court criticized the Champion opinion over this point, and indeed in Fresh International the court found abstention when the challenge was to just one commission order. (See Fresh at page 1360 fn. 9),

Moreover, the Fresh International court found that in the case considered by Champion preemption was clear and "readily apparent", noting that Champion was decided shortly after a similar Supreme Court case finding preemption by ERISA when state laws imposed obligations that were inconsistent with ERISA (at page 1361). In our instant case there is no conflict or inconsistencies in the federal and the state law; to the contrary, the Department's order concerns offerings that do not comply with Regulation D. Champion is further distinguishable from this instant case in that the employer there had complied with ERISA, unlike the plaintiffs here who have not complied with the exemption restrictions of Regulation D.

In Fresh International the court held that California had an important state interest, and that because preemption was not clear or "readily apparent" in the case before it, California's interest was not superseded by preemptive federal law, and abstention was ordered. (at page 1362.) As shown by the Department, preemption in this instant case is certainly not clear or "readily apparent" as the plaintiffs unsuccessfully argue. To the contrary, what is clear under NSMIA is that no security offering under Regulation D is preempted unless it is exempt. The court is respectfully requested to abstain from hearing this action.

3. PLAINTIFFS FAILED TO ALLEGE FACTS THAT THEY HAVE SUFFERED A SIGNIFICANT THREAT OF IRREPARABLE INJURY OR THAT THE BALANCE OF HARDSHIPS FAVORS THE INJUNCTION THEY SEEK

Clearly the plaintiffs have failed to allege facts that support a request for injunctive relief. The Desist and Refrain Order only requires that if plaintiffs do not wish to register/qualify their offering in California, that their offers comply with the exemption they claim, specifically the private



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offering exemption Rules under Regulation D. Plaintiffs cannot and do not dispute that their offers should comply with Regulation D. This is hardly a "harm" that can support a claim for injunctive relief. This is hardly an "irreparable injury" either since the plaintiffs need only comply with the law to repair their alleged injury.

The only harm the plaintiffs allege is the result of their failure to comply with Regulation D restrictions. The plaintiffs try to argue that it is not just having to comply with the law that is harming them, but that their offers may be scrutinized by more than one regulatory body. They argue that only the SEC should be able to enforce Regulation D's restrictions against general solicitation. They are saying that their offers should be subject to less scrutiny, and that cannot be rationally considered a harm that can support a request for injunctive relief.

4. THERE IS NO PREEMPTION BECAUSE THE TRANSACTION WAS NOT EXEMPT

In their opposition to this motion to dismiss, the plaintiffs incorrectly state that they only need to demonstrate their compliance with the notice filing statute in California to show they are entitled to preemption under NSMIA. For alleged support plaintiffs refer to their argument concerning preemption found in their reply brief in support of their Motion for a Preliminary Injunction.

The plaintiffs totally ignore the unambiguous and express terms of NSMIA codified in 15 U.S.C. section 77r, that a security is a "covered security" only if it "is exempt". Similar language is found in Corporations Code section 25102.1(d), permitting "notice filing" of a Regulation D exemption, but only if the security actually "is exempt" from registration under Regulation D.

The court in Halbert Lumber Inc. v Lucky Stores (1992) 6 Cal App.4th 1233, 1238-1239 discussed the maxims of statutory interpretation. "First, a court should examine the actual language of the statute. (Citations.)…in examining the language, the courts should give to the words of the statute their ordinary, everyday meaning (Citations.)….If the meaning is without ambiguity, doubt, or uncertainty, then the language controls. (Citations.)" The plaintiffs citation of cases that consider the interpretation of ambiguous statutes is inapplicable, and they resort to a smokescreen when they attempt to draw this court's attention to parts of the statute other than 77r(b)(4), the very provision that expressly states that a security that is entitled to the preemption aspects of NSMIA is a security that is exempt.



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The plaintiffs try to distinguish the cases that have held that there is no NSMIA preemption without exemption, (eg. Buist v Time Domain, Hamby v Clearwater Consulting, and Grubka v Webaccess), on the basis that those courts considered preemption when it was raised by defendants as an affirmative defense. That is an immaterial distinction and the mere result of the issuers offering securities in those cases being made defendants, while the issuers in this instant case (who were themselves initially respondents or "defendants" in the administrative hearing) have now made themselves plaintiffs by filing their insufficient complaint.

5. THE COMMISSIONER HAD AUTHORITY TO ISSUE THE DESIST AND REFRAIN ORDER BECAUSE THE TRANSACTION WAS NOT EXEMPT UNDER CALIFORNIA LAW AND REGULATION D.

Whether intentionally or not, the plaintiffs have failed to respond to this additional basis for dismissal, that the Department had authority to issue the Desist and Refrain Order because the California transactions were not exempt under California law and Regulation D. It is not refuted that the Department had authority to issue its Order under California's enabling code, C.C. section 25532(a), so long as the securities were offered without being first registered/qualified or without meeting the requirements of C.C. section 25102.1 providing protection only for offerings that are exempt under Regulation D.

6. PLAINTIFFS HAVE FAILED TO STATE A CLAIM UNDER 42 USC 1983.

The plaintiffs fail to directly respond to the Department's additional basis for dismissal, that because the plaintiffs have not alleged compliance with the requirements of Regulation D they have not stated a claim under federal law. The plaintiffs' only response is that they have pled all necessary elements of their claim. No doubt because they cannot allege compliance with Regulation D, the plaintiffs' position is that they need not allege compliance.

As shown in the Department's moving papers, the pled facts on which plaintiffs rely do not support a claim for relief. The plaintiffs have alleged only that they filed forms with the SEC and in California claiming that they were offering securities exempt from registration under Regulation D. The plaintiffs' unsupported position is that once they filed these notice forms, California was preempted whether or not plaintiffs engaged in public offerings or general solicitation.



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As the Department has shown, unless there has been compliance with Regulation D, plaintiffs cannot claim their offerings in California met the federal or state registration/qualification exemption requirements or were "covered securities" that would provide preemption protection. The plaintiffs have not and cannot allege that their offerings were exempt, and therefore they cannot state a claim in this court. This action should be dismissed.

7. THE ELEVENTH AMENDMENT BARS THIS CLAIM AGAINST THE CALIFORNIA DEPARTMENT OF CORPORATIONS, A SUBDIVISION OF THE STATE OF CALIFORNIA AND PRESTON DuFAUCHARD, THE CORPORATIONS COMMISSIONER.

The Department has adequately demonstrated that the plaintiffs can state no valid Constitutional claim or cause of action based on 42 U.S.C. section 1983, and this case should be dismissed under the Eleventh Amendment. In an effort to see if anything will stick, the plaintiffs proclaim that the Department of Corporations must show that it qualifies as an arm of the State before the Eleventh Amendment immunity applies, but nowhere do plaintiffs go so far as to claim the Commissioner is not an arm of the State because that is a red herring.

8. PLAINTIFFS FAILED TO PROVIDE A "SHORT AND PLAIN STATEMENT" OF FACTS AND AS A RESULT, DEFENDANTS CANNOT BE SURE WHAT FACTUAL ALLEGATIONS REQUIRE A RESPONSE.

If this action is not dismissed, the plaintiffs should be made to amend their complaint to provide a short and plain statement of facts.

9. THIS ACTION IS BARRED AS AGAINST PRESTON DuFAUCHARD, CORPORATIONS COMMISSIONER SINCE HE HAS QUALIFIED IMMUNITY PURSUANT TO GOVERNMENT CODE §821.6, AND CORPORATIONS CODE §25531 AND §25532.

In the plaintiffs opposition they fail to address, in any serious fashion, this moving party's argument and legal authority that plaintiffs are barred from naming as defendants Department employees, specifically Preston DuFauchard as Commissioner. The plaintiffs claim the Department's authorities apply only when there is civil liability or a physical injury, but the plaintiffs are alleging harm resulting from an employees investigation and prosecution of an administrative proceeding, and as stated by the court in Javor v. Taggart (2002) 98 Cal.App.4th 795, 808, quoted in the Department's moving papers, that is clearly considered protected behavior. If the court does not dismiss this entire action it is respectfully requested that at least Commissioner Preston DuFauchard be dismissed as a named defendant.

C. CONCLUSION

This court is respectfully requested to dismiss this action.

DATED: August 18, 2006

Respectfully submitted,
PRESTON DuFAUCHARD
California Corporations Commissioner

By /s/ Edward Kelly Shinnick
EDWARD KELLY SHINNICK
Corporations Counsel

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