ARIZONA CORPORATION COMMISSION
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STATE OF ARIZONA

MARICOPA COUNTY SUPERIOR COURT

ARIZONA CORPORATION COMMISSION Plaintiff v. DENSCO INVESTMENT CORPORATION, an Arizona corporation Defendant.	No. CV CV2016-014142 **MEMORANDUM OF POINTS AND AUTHORITIES IN SUPPORT OF APPLICATION FOR PRELIMINARY INJUNCTION AND APPOINTMENT OF RECEIVER**

I. INTRODUCTION.

Plaintiff, the Arizona Corporation Commission (the "ACC"), submits this Memorandum of Points and Authorities In Support of its Application for Preliminary Injunction and Appointment of Receiver to protect its ability to recover investor funds from Defendant. This matter involves violations of the Arizona Securities Act in which Defendant raised at least $50 million dollars from over 100 investors through the offer and sale of securities in the form of notes within or from Arizona.

II. FACTS

Based upon the investigation conducted by the ACC, the Defendant appears to have raised over $50 million from at least 100 investors. Unfortunately, the sole officer/director/shareholder of

the Defendant passed away suddenly and there is no one in charge of the Defendant to handle business matters and preserve assets.

Defendant offered to individuals the opportunity to invest in General Obligation Notes ("Notes") of DenSco. The Notes were to be "secured by a general pledge of all assets owned by or later acquired by the Company." DenSco's largest assets would be in Trust Deeds. DenSco was to maintain a loan-to-value ratio at 70% percent or below in the aggregate for all loans in the loan portfolio.

Based upon information and belief, since at least 2009, DenSco "has been . . . engaged primarily in funding purchases of houses through preforeclosure process, foreclosure sales and funding and purchasing construction loans, all of which will be secured by real estate deeds of trusts." The Notes received interest only payments during the term and principal paid at maturity. Interest may be paid monthly, quarterly or at maturity.

According to the Defendant's website, "DenSco will target the funding of Trust Deeds on Real Estate that is highly marketable, has sufficient equity, and the borrower is competent in fulfilling the obligation of the note; while providing investors a constant rate of return on their investment backed by a diversity of these properties with a strong loan-to-value ratio. Most of these loans will be to Residential and Commercial Foreclosure Specialists that will renovate and then flip the properties in a relatively short period of time."

The offering document specifically states that "Trust Deeds have a loan-to-value ratios, no greater than 70 percent but with an objective goal of 50 percent to 60 percent." At least one borrower received loans totaling 100 percent of the loan-to-value.

The Lending Guidelines listed on Defendant's website specifically state "First Position ONLY!" The Lending Guidelines further stated that DenSco would lend up to 60% to 70% of the value of the property. According to the investors, DenSco requires borrowers to put at least 20% down on the home purchase and DenSco has a first position security interest in the real estate. Therefore the investors are protected even if the borrower defaults.

Between 2013 and September of 2015, DenSco stopped accepting new investors and new money from current investors.

Upon information and belief, starting in about 2013, Densco started providing investor funds to a borrower without obtaining a first position deed of trust on the real property. This activity involved about 80 loans and at least $28 million. This is contrary to what was explained to investors and contrary to the description in the offering documents and website. Further, the same borrower obtained an apparent unsecured loan of over $14 million.

At some point, DenSco and the borrower described above reached a forbearance agreement. In about October of 2015, the borrower failed to make its payments. This borrower sought protection under Chapter 7 of the U. S. Bankruptcy Code.

After September of 2015, upon information and belief, DenSco began accepting investor funds again. Upon information and belief, no disclosure was made to those investors that a large borrower had failed to make payments on previous loans. Nor were investors told that DenSco was not in a first position on many deeds of trust.

Since at least 2009, the Defendant, directly or indirectly, raised at least $50 million through at least 103 investors.

Upon information and belief, there appears to be a total of 138 outstanding loans[1] in Defendant's portfolio. Only 50 of those loans appear to be performing as represented to investors. The estimated value of the 50 loans is about $4.9 million. Another five of the loans will require collection or foreclosure and are secured with a first deed of trust. The estimated value of the five loans is about $2.5 million. At least 83 of the loans, to the same borrower, do not appear to be performing. In addition, it appears that the loans are unsecured. The value of the 83 loans is about $28 million. It appears that Defendant provided an unsecured note to the borrower of the 83 loans mentioned above in an amount about $14 million. Defendant does have liquid assets in the amount of about $1.5 million.

[1] These figures are based upon company records and have not been independently verified.

III. LEGAL ANALYSIS.

A. The Investments Offered By The Defendant Are Securities.

1. The Promissory Notes are "Securities."

Defendant issued promissory notes to individual investors as evidence of the investments. The Notes are securities because they are promissory. The Securities Act defines a security as an "note." A.R.S. § 44-1801(26). While a promissory note is presumed to be a security, the Supreme Court has identified certain types of notes that are excluded from the definition of security. *See Reves v. Ernst & Young*, 494 U.S. 56, 65 (1990); *MacCollum v. Perkinson*, 185 Ariz. 179, 913 P.2d 1097 (App. 1996)(adopting the *Reves*' test in Arizona.). In *Reves*, the Supreme Court held that every promissory note is a security unless it bears a strong "family resemblance" to a judicially crafted list of non-securities. *Reves*, 494 U.S. at 65. The parties may rebut the presumption by examining a note transaction in light of four factors. *Id.* at 66-67: Instruments do not have a familial resemblance to one of the excluded categories and, thus, are considered to be securities if (1) the seller's motivation is to raise money or finance investments and the buyer's purpose is to make a profit; (2) there is common trading of the instrument for speculation or investment; (3) the public expects that the instrument is a security; and (4) there is no other regulatory scheme to significantly reduce the risk of the instrument, thereby rendering the application of the securities laws unnecessary. *Id.* Applying the "familial resemblance" test, the Notes do not bear a family resemblance to any of the categories listed in *Reves*, and thus are securities.

B. The Defendant violated the Antifraud Provisions of the Arizona Securities Act.

Under A.R.S. § 44-1991, it is a fraudulent practice and unlawful for a person, in connection with a transaction or transactions within or from this state involving an offer to sell or buy securities, or a sale or purchase of securities, to directly or indirectly do any of the following: make

untrue statements of material fact, or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading; or engage in any transaction, practice or course of business which operates or would operate as a fraud or deceit. A.R.S. § 44-1991(A)(2)(3). Securities fraud may be proven by any one of these acts. *Hernandez v. Superior Court*, 179 Ariz. 515, 880 P.2d 735 (App. 1994).

In the context of these provisions, "materiality" requires a showing of substantial likelihood that, under all the circumstances, the misstated or omitted fact would have assumed actual significance in the deliberations of a reasonable buyer. *Trimble v. American Sav. Life Ins. Co.*, 152 Ariz. 548, 553, 733 P.2d 1131 (1986). Under this objective test, there is no need to investigate whether an omission or misstatement was actually significant to a particular buyer. Additionally, the affirmative duty not to mislead potential investors in any way places a heavy burden on the offeror and removes the burden of investigation from the investor. *Trimble*, 152 Ariz. at 553. A misrepresentation or omission of a material fact in the offer and sale of a security is actionable even though it may be unintended or the falsity or misleading character of the statement may be unknown. In other words, scienter or guilty knowledge is not an element of a violation of A.R.S. § 44-1991(2). *See e.g., State v. Gunnison*, 127 Ariz. 110, 113, 618 P.2d 604 (1980). Stated differently, a seller of securities is strictly liable for any of the misrepresentations or omissions he makes. *Rose v. Dobras*, 128 Ariz. at 214. Additionally, there is no requirement to show that investors relied on the misrepresentations or omissions, *Rose*, 128 Ariz. at 214, or that the misrepresentations or omissions caused injury to the investors. *Trimble*, 152 Ariz. at 553. A primary violation of A.R.S. § 44-1991 can be either direct or indirect. It is now well-settled in Arizona that *indirectly* violating A.R.S. § 44-1991 is not to be narrowly interpreted. *Barnes v. Vozack*, 113 Ariz. 269, 550 P.2d 1070 (1976)(Officers of company could be liable under A.R.S. § 44-1991 for the fraudulent statements of a salesman of the security.)

As set forth in the Verified Complaint and supported by the attached Affidavit of Gary Clapper, the Defendants have violated A.R.S. §44-1991 by: (1) misrepresenting to investors that DenSco would loan up to 70% of the value of the property, when in fact, with at least one borrower, DenSco provided $28 million in loans at 100 percent of the value of the property; (2) failing to disclose to investors that many loans were not secured with a first position deed of trust; (3) failing to disclose to investors after October 2015, that at least one borrower had failed to make payments on over $28 million in loans; and (4) failing to disclose to investors that DenSco provided over a $14 million unsecured loan. Any *one* of these actions would violate the Securities Act.

IV. REQUESTED RELIEF

A. Preliminary Injunctions are Appropriate.

A.R.S. § 44-2032(2) authorizes the ACC to seek injunctive relief when it appears that a person has engaged in, is engaging in or is about to engage in act, practice or transaction in violation of the Securities Act. A.R.S. § 44-2013(A) provides that the ACC may request that the Superior Court issue a preliminary injunction restraining the Defendant from removing, encumbering or otherwise disposing of the property located within this state.

Preliminary injunctive relief against Defendant is appropriate. The Defendant has no officer/director/shareholder to wind-up the affairs of the entity. Based upon the information contained in the Clapper affidavit attached, there are substantial assets including real estate that need to be managed for the protection of the investors. In addition, there are many claims the Defendant may be able to assert to protect the investors funds.

B. Appointment of a Receiver is Appropriate

As set forth above, pursuant to the Securities Act, courts may order appointment of a Receiver to preserve Defendant's assets and to ensure that investors are protected from unlawful conduct. A.R.S. § 44-2013. The ACC requests the appointment of a receiver to preserve the assets

in the possession of, or under the control of the Defendant. As is shown by the Affidavit of Gary Clapper, there are substantial real property assets that need to be liquidated and liquid assets that need to be preserved for the benefit of the investors. It would be impossible to make the investors whole without all of the funds and/or assets. As stated herein, a receiver is necessary to safeguard funds and preserve assets for the benefit of the investors. A receiver is necessary here to marshal, liquidate and distribute assets.

VI. CONCLUSION

Based on the foregoing facts and for the reasons set forth above, the ACC respectfully requests that the Count enter the attached order.

Dated this 17th day of August, 2016.

ARIZONA CORPORATION COMMISSION
By
Wendy Coy
Attorney for the Arizona Corporation Commission

STATE OF ARIZONA)
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County of Maricopa)
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AFFIDAVIT OF GARY CLAPPER

I, Gary Clapper, being duly sworn, say as follows:

1. I am a resident of Maricopa County, Arizona and am over the age of eighteen (18).

2. I have personal knowledge of the matters stated in this affidavit and am competent to testify to them.

3. I understand that this affidavit may be used in a court of law.

4. I am the Chief Investigator for the Securities Division of the Arizona Corporation Commission ("Commission").

5. I am assigned to assist in the investigation involving DenSco Investment Corporation ("DenSco").

6. According to the Arizona Corporation Commission, Corporations Division website, DenSco is incorporated in Arizona. DenSco was formed April 30, 2001, and has an address within Maricopa County.

7. I obtained a copy of the DenSco 2009 Private Placement Offering Memorandum ("offering document"). A number of investors have stated that the offering documents were provided to them prior to making an investment in DenSco.

8. According to the offering document obtained from an investor, DenSco intended to offer general obligations notes ("Notes") to investors. The investors' funds were to be used to lend money to "Foreclosure Specialists" for the purchase of foreclosed/distressed properties, both residential and commercial. This information was confirmed during interviews with investors.

9. The Notes offered to investors were to be secured through the assets of DenSco which mainly consisted of first lien positions Deeds of Trust. This information was confirmed during investor interviews, a review of the offering document and DenSco's website.

10. The Notes issued to the investors directed monthly or quarterly interest payments with the principle being paid at maturity. This information was confirmed during investor interviews and a review of the offering document.

11. DenSco would loan money to borrowers. The property loan to value was to be no greater than 70% of the property value. This information came from investor interviews, a review of the offering document and DenSco's website.

12. According to investor interviews, in about 2013, DenSco stopped accepting new investor money. Since September of 2015, DenSco began accepting new investors and additional investments from current investors.

13. During the course of the investigation, it was discovered that DenSco had lent money to at least one borrower without DenSco secured in the first position on the Deeds of Trusts. This activity involved about 80 of the 138 properties currently with outstanding loans and totaled about $28 million. This borrower stopped making payments in about October of 2015.

14. This same borrower also received an unsecured loan from DenSco for $14 million and has defaulted on that loan.

15. According to information obtained during the investigation, DenSco raised approximately $50 million from about 103 investors.

16. Information provided to investors disclosed the following;

a. $1 million in DenSco bank accounts

b. $4,981,736 in Notes that are believed to be secured by deeds of trust and should be liquidated in the near future.

c. $2,533,000 Notes that are secured but need collection.

d. $28,178,600 Notes that appear to unsecured.

e. $14,339,339 in an unsecured Note.

17. Based upon information obtained in the investigation, the sole officer/director/shareholder of DenSco is deceased. To my knowledge there are no employees

or other officers of DenSco. The Personal Representative of the individual's estate is not interested in operating DenSco. The Personal Representative resides outside of Arizona.

Gary R Clyn
(Signature)

SUBSCRIBED AND SWORN TO BEFORE me this 17th day of August, 2016.

NOTARY PUBLIC

My Commission Expires:

10-06-19

Notary Public State of Arizona
Maricopa County
Michael Duane Brokaw
My Commission Expires 10/06/2019