

UNITED STATES DISTRICT COURT
DISTRICT OF RHODE ISLAND

SECURITIES AND EXCHANGE COMMISSION,)
)
Plaintiff,)
)
vs.) Case No. 15-CV-00191-S-LDA
)
PATRICK CHURCHVILLE,)
CLEARPATH WEALTH MANAGEMENT, LLC,)
)
Defendants,)
)
and)
)
CLEARPATH MULTI-STRATEGY FUND I, L.P.,)
CLEARPATH MULTI-STRATEGY FUND II, L.P.,)
CLEARPATH MULTI-STRATEGY FUND III, L.P.,)
HCR VALUE FUND, L.P.,)
)
Relief Defendants.)

**RECEIVER’S MOTION FOR AN ORDER APPROVING
DISTRIBUTION PROCEDURES AND CERTAIN OTHER RELATED RELIEF**

Now comes Stephen F. Del Sesto, Esq. solely in his capacity as the Court-appointed Receiver for Defendants Patrick Churchville and ClearPath Wealth Management, LLC and Relief Defendants ClearPath Multi-Strategy Fund I, L.P., ClearPath Multi-Strategy Fund II, L.P., and ClearPath Multi-Strategy Fund III, L.P. (collectively “Receivership Entities”), and respectfully submits this Motion (the “Motion”) for an Order Approving Distribution Procedures and Certain Other Related Relief. In support of the Motion, the Receiver respectfully submits as follows:

I. PRELIMINARY STATEMENT

As this Court is aware, the Receiver and his professionals (collectively the “Receivership Team”) have undertaken and continue to undertake efforts to identify, collect and liquidate the assets of the estate of the Receivership Entities, and to permit persons and entities that assert that they are owed money by the Receivership Entities (singularly or collectively) and/or have suffered damages arising from the

actions of the Receivership Entities to file Claims¹ against the Receivership Entities through the use of the submission of claims process (the “Claims Process”) previously approved by this Court. In the course of this process, the Receivership Team faced numerous challenges in seeking to establish the appropriate value of claims and provide the greatest return to the victims of this Ponzi scheme.

Many of the challenges that arose in regard to the Claims Process were anticipated and addressed by the Receivership Team through the inclusion of various safeguards in the Claims Process. Those safeguards; however, were unable to resolve several additional issues, including, but not limited to: (1) Claimants who failed to provide adequate or any information to reconcile claims; (2) Claimants who included losses related to legitimate investments as part of their claims; (3) Claimants who included unrealized but “promised investment return” as part of their claims; (4) Claimants who sought to mislead the Receivership Team; or (5) issues that were not anticipated by the Receivership Team when the Claims Process was approved.

After a preliminary review of filed Claims, the Receivership Team identified numerous issues that needed further attention, including, without limitation, (1) Claimants who filed Claims with incomplete information, (2) Claimants who filed Claims on behalf of other Claimants, (3) Claimants who failed to provide adequate information to readily identify the claimant, (4) Claimants that asserted amounts far in excess of their actual investment/damages, and (5) persons that improperly filed Claims based upon non-Ponzi scheme related investments (i.e. apparent legitimate investments that did not yield a positive return for the investor). Unfortunately, the issues caused by the conflicting and unclear information, coupled with the state of the Defendant Entities’ records at the time of the Receiver’s appointment, have complicated the Claims reconciliation process.

¹ Capitalized terms used, but not defined herein, shall have the meanings ascribed them in the Receiver’s Motion to Establish a Claims Bar Date, Approve the Manner and Form of Notice of Claims Bar Date and Approve the Process for Submitting Claims and its Exhibits (Document No. 66).

The Receivership Team has proceeded with claims reconciliation process in earnest in an effort to address all claims that have been properly filed with the Receiver. In order to complete the Claims reconciliation process, promote efficiency in the administration in this Case, and to establish the methodology for making distributions, the Receiver hereby seeks the approval of the following relief: (1) the establishment of the priority of distributions to the holders of allowed Claims; (2) the establishment of the rising tide methodology for determining the distributions to be made on account of the allowed Claims; and (3) the establishment of the procedures for making distributions.

II. BACKGROUND

Churchville and ClearPath managed a series of private investment funds that were structured as limited liability partnerships. ClearPath was the adviser to at least four affiliated private funds, pursuant to management agreements between ClearPath and each of the funds: ClearPath Multi-Strategy I, LLC; ClearPath Multi-Strategy II, LLC; ClearPath Multi-Strategy III, LLC; and HCR Value Fund GP, LLC (the “Funds”).² Churchville and ClearPath organized the Funds in a complex Series structure. It appears that the Funds retained ClearPath to provide investment advice, in exchange for management fees, expense reimbursement and placement fees.³ The investors in each of the private funds held limited partnership interests in those Funds pursuant to Limited Partnership Agreements between the limited partners and the Funds.

The Limited Partnership Agreements for each Fund provide that Fund assets and capital were divided into separate Series, which in turn are accounted for as sub-partnerships within the Fund. In practice, each Series in the ClearPath funds was comprised of a distinct portfolio investment, and investors subscribed specifically to the particular Series in which they wanted to

² ClearPath Multi-Strategy I, LLC is the general partner of the CPMSF I fund. ClearPath Multi-Strategy II, LLC is the general partner of CPMSF II. ClearPath Multi-Strategy III, LLC is the general partner of CPMSF III. HCR Value Fund GP, LLC is the general partner of HCR Value.

³ ClearPath was also entitled to receive a success fee from CPMSF III.

invest. Because each Series within the Funds was supposed to be accounted for as a separate sub-partnership, ClearPath provided investors with capital account statements specific to their Series, rather than to the Fund overall. As a result, distributions attributable to redemption of the portfolio investment associated with a particular Series were to be made only to those investors participating in those Series. Further, Investors were to receive distributions or other funds only from their interest in the Series, as opposed to the Fund overall. In essence, the investors owned investments in particular portfolio companies, while the portfolio companies were administered under the umbrella of the overall Fund, which paid ClearPath its management fees and other compensation. The Series were offered to Investors in a variety of different types of investments, including commercial secured loans, collections of other private funds, direct investments in private companies, and an investment in publicly traded equities and bonds.

On or about May 7, 2015, the Securities and Exchange Commission (“SEC”) commenced a civil enforcement action (the “Enforcement Action”) against Churchville and the Receivership Entities. See Complaint filed May 7, 2015 (the “SEC Complaint”) (Document No. 1). The SEC Complaint alleges that Churchville, through ClearPath engaged in (1) fraud in connection with the purchase or sale of securities, in violation of Section 10(b) of the Securities Exchange Act of 1934 (“Exchange Act”) and Rule 10b-5 thereunder; (2) fraud in the offer or sale of securities, in violation of Section 17(a) of the Securities Act of 1933 (“Securities Act”); (3) fraudulent conduct by an investment adviser, in violation of Sections 206(1) and 206(2) of the Investment Advisers Act of 1940 (“Advisers Act”); and, (4) fraudulent conduct by an investment adviser to a pooled investment vehicle, in violation of Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder. Additionally, the SEC Complaint alleges that ClearPath failed to (a) comply with rules promulgated under the Advisers Act related to the custody of funds or securities of clients, in violation of Section

206(4) of the Advisers Act and Rule 206(4)-2 thereunder; and, (b) adopt, implement, and annually review written policies and procedures reasonably designed to prevent violation, by ClearPath and ClearPath's supervised persons, of the Advisers Act and the rules promulgated under the Advisers Act, in violation of Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder. Finally, the Complaint alleges that Churchville aided and abetted ClearPath's violations of Section 206(4) of the Advisers Act and Rules 206(4)-2 and 206(4)-7. The SEC sought equitable relief, including injunctions against future violations of the securities laws, injunctions against the issuance, purchase, offer or sale of any securities, orders freezing all assets, disgorgement, prejudgment interest, civil monetary penalties and the appointment of a receiver.

Subsequent to the filing of the SEC Complaint, on or about June 2, 2015, the SEC and the Receivership Entities consented to the immediate entry of an order imposing preliminary injunction, freezing assets and for other equitable relief. See Order Imposing Preliminary Injunction, Freezing Assets and for Other Equitable Relief filed June 2, 2015 ("Freeze Order") ((Document No. 13). Soon thereafter, on or about July 14, 2015, the SEC filed a Motion for Appointment of a Receiver and Motion for Order Concerning HCR. Based upon those Motions, on or about July 30, 2015, the Court entered an Order Appointing Receiver and Order Concerning HCR. See Order Appointing Receiver ("Appointing Order") (Document No. 16) and Order Concerning HCR ("HCR Order") (Document Nos. 15-1 and 17), respectively.

On May 1, 2016, the Receiver filed a Motion for Order seeking to Establish a Claims Bar Date, Approve the Manner and Form of Notice of Claims Bar Date and Approve the Process for Submitting Claims (the "Claims Motion") (Document No. 66). On September 23, 2016, this Court entered an Order Approving the Claims Motion and established (i) Claims Process, (ii) Claims Bar Date, and (iii) Claims Notice Procedures ("Order Approving Claims Process") (Document No. 87),

which commenced the process for all Claimants of the Receivership Entities to assert their Claims (the “Claims Process”). On October 6, 2016, the Receiver delivered notice of the Order Approving Claims Process and the Claims Process to all investors and other claimants.

III. RELIEF REQUESTED

A. Claims Related Issues

Shortly after the commencement of the Claims Process, the Receivership Team began receiving and reviewing the investment information provided by Claimants in the Claims Process in order to investigate the accuracy of the information being provided by Claimants. It became readily apparent from the initial review of the information provided by Claimants that information being provided by some Claimants was unclear or unverifiable against the Receivership Entities records, and that such information likely would require detailed analysis in order to determine the allowability of the Claim or a portion thereof being asserted. Indeed, as discussed above, preliminary reviews of Claims showed, among other things, (1) some Claimants filed Claims with incomplete information or provided false information, (2) some Claimants filed Claims on behalf of other Claimants without proof of authority to do so, (3) some Claimants asserted amounts far in excess of their actual investment/damages, and (4) persons that improperly filed Claims based upon non-Ponzi scheme related investments (i.e. apparent legitimate investments that did not yield a positive return for the investor). Moreover, even those Claims asserted where the Receiver was able to match substantial investment amounts, in many cases, the Receivership Entities’ records did not completely match the information provided by such Claimants.

The vast majority of the more than 150 Claims that have been filed have been filed by Investors. The majority of these Investors assert suffered losses based on the investments they made to the Receivership Entities in connection with the Ponzi scheme. All of these Claims generally arose from similar facts and it is unlikely that reconciliation of these Claims will involve complex legal issues or

factual disputes, although each Claim has required detailed analysis. In an effort to avoid inundating this Court with claim disputes, the Receiver proposes the procedures set forth herein to address these potential disputes and conserve judicial resources.

The Order Approving Claims Process (Document No. 87) contemplated that the Receiver would issue Claim Determinations on all Claims and attempt to resolve any discrepancies through negotiations with Claimants. If those negotiations failed, then this Court would resolve the dispute. Despite the Receivership Team's best efforts, some objections to Claim Determinations will require some form of third-party intervention. In order to prevent this Court from being inundated with litigation regarding Claims resolutions, it seems clear to the Receiver that, due in large part to the potential number of Claimants that may dispute the amount asserted by the Receiver, it may be prudent to develop an alternate procedure to resolve objections to Claim Determinations where direct negotiation with the Claimants fails or in instances where the Receiver considers the position of the Claimant and decides that it would be in the best interest of the Estate to agree to a number different than that contained in the initial Claim Determination.

1. Amendment of Claim Determinations

After consultation with his advisors, the Receiver believes that it is in the best interest of the Estate to permit the Receiver, in his discretion, to amend and reissue Claim Determinations in instances where the Receivership Team determines that the original Claim Determination did not accurately reflect the proper amount of the Claim asserted by the Claimant. In those instances the Receiver should be permitted to revise Claim Determinations and reissue such amended Claim Determinations in his discretion.

2. Procedures for Settlement of Objections to Claim Determinations

Additionally, the Receiver believes it is in the best interest of the Estate to permit him to settle objections to Claim Determinations. This Court previously approved the Claim Dispute Process, under

which the Receiver will issue a Claim Determination and, if disputed, a period of negotiation between the Receivership Team and the Claimant would commence. In instances when the Receiver and the Claimant reach agreement as to the amount of such Claim, this Court should approve the following procedures for settling such Claims.

The Receiver requests authority to stipulate to the allowance of a Claim against the Receivership Entities without the approval of this Court so long as the Claim, as allowed, does not exceed an amount that is five percent (5%) greater than the amount such Claim was maintained in the Receivership Entities' records. In instances where the Receiver has determined that it is in the best interest of the Estate to stipulate to the allowance of a Claim that would be in an amount that is in excess of five percent (5%) more than the amount that such Claim was maintained in the Receivership Entities' records the Receiver will file a motion for approval with this Court.⁴

In order to determine whether a settlement of a claim is in the best interest of an estate, courts have found that the compromise proposed must be fair and equitable, reasonable and in the best interests of that estate. See Protective Comm. For Index. Stockholders of TMT Trailer Ferry, Inc. v. Anderson, 390 U.S. 414, 424 (1968). In assessing the adequacy of a proposed settlement, courts have considered (1) the probability of success in the litigation for the estate; (2) the difficulties associated with collection; (3) the complexity of the litigation; (4) the attendant expense, inconvenience and delay; and (5) other factors relevant to a full and fair assessment of the wisdom of the proposed compromise. See id.; see also In re Derivium Capital, LLC, 380 Bankr. 392, 405 (Bankr. D.S.C. 2007). Because this Court would consider these factors when determining whether to approve a proposed settlement, the Receiver will utilize these principles to determine whether to agree to a settlement.

⁴ The Receiver may seek this Court's approval of multiple settlements in one motion (an "Omnibus Motion"). Any such Omnibus Motion will clearly identify each of the settlements for which the Receiver is seeking approval.

This settlement protocol will permit the Receiver to efficiently administer the Claims process and resolve matters that would otherwise require intervention by the Court without needlessly involving the Court if a compromise can be reached.

B. Priority of Claims

SEC Receiverships are equitable proceedings that seek to redistribute the proceeds of a fraud to the victims of the underlying entity. Unlike a case arising under title 11 of the United States Code, there is no statutory mandate that prescribes how the assets recovered in a receivership should be distributed. Thus, it is within a receiver's discretion to create a plan of distribution that classifies claims into different classes for treatment of differing payment terms using equitable notions. See SEC v. Credit Bancorp, Ltd., 290 F.3d 80, 91 (2d Cir. 2002); SEC v. Basic Energy & Affiliated Res., Inc., 273 F.3d 657, 668 (6th Cir. 2001); SEC v. Forex Asset Mgmt. LLC, 242 F.3d 325, 328 (5th Cir. 2001); SEC v. Elliott, 953 F.2d 1560, 1566-67 (11th Cir. 1992); SEC v. Hardy, 803 F.2d 1034, 1037-39 (9th Cir. 1986); see also Kathy Bazoian Phelps, Handling Claims in Ponzi Scheme Bankruptcy and Receivership Cases, 42 Golden Gate U.L. Rev. 567, 572-73 (2012). This Court, therefore, has discretion in approving a distribution plan that provides for varying treatment among different types of creditors.

Pursuant to these broad discretionary powers, courts tasked with overseeing the administration of a receivership for a Ponzi scheme may authorize any distribution protocol for receivership assets on account of allowed claims that is "fair and reasonable" in the overseeing court's opinion. CFTC v. Barki, LLC, No. 3:09 CV 106-MU, 2009 WL 3839389 (W.D.N.C. Nov. 12, 2009); SEC v. Wealth Mgmt. LLC, 628 F.3d 323, 332-33 (7th Cir. 2010); SEC v. Wang, 944 F.2d 80, 81-5 (2d Cir. 1991); SEC v. Byers, 637 F. Supp. 2d 166, 174 (S.D.N.Y. 2009) (citing Wang).

After due consideration, the Receiver has determined that it is fair and reasonable to make distributions on account of allowed Claims in the following manner (collectively, the “Distribution Protocol”):

(1) First, on account of Claims for the actual necessary costs and expenses incurred by the Receiver and the Receivership Team subsequent to the appointment of the Receiver, including, but not limited to, the payment of the fees authorized by this Court, tax obligations that are incurred from activities undertaken subsequent to the appointment of the Receiver (not tax obligations that merely become due subsequent to the appointment of the Receiver), and the fees and costs associated with making distributions of the assets collected by the Receivership Team to holders of allowed Claims in this case (collectively, “Class 1 Claims”) until such Claims are paid in full. The Receiver believes that the Receivership Team has collected sufficient assets so that all such Class 1 Claims will be paid in full from the assets of the Estate;

(2) Second, on account of allowed secured Claims, including, without limitation, the allowed secured Claims of taxing authorities, until such claims are paid in full, but solely from the proceeds of the collateral held by the Estate in which the secured Claim holder holds an interest (collectively, “Class 2 Claims”). The Receiver does not believe there are any allowable secured Claims and does not anticipate locating any such Claims in the Claim reconciliation process or making any distributions on account of any such Claims;

(3) Third, pro-rata to holders of allowed Claims of Investors on account of the allowed Claims of Investors (collectively, “Class 3 Claims”) until all such claims are paid in full without interest, costs or fees. The Receiver believes he will be able to make pro-rata distributions on account of allowed Class 3 Claims that are allowed in the Claims reconciliation process, but will be unable to pay such Claims in full without interest, costs or fees;

(4) Fourth, to the extent not paid in full above and solely to the extent there are remaining funds after payment in full is made on account of all allowed Claims in Classes 1, 2 and 3 in accordance with the treatment set forth above, pro-rata to holders of allowed Claims of taxing authorities and other governmental entities allowed in the reconciliation process (collectively, “Class 4 Claims”) until such Claims are paid in full without interest, costs, penalties or fees; and

(5) Finally, to the extent there are remaining funds after payment in full is made on account of all allowed Claims in Classes 1, 2, 3 and 4 in accordance with the treatment set forth above, pro-rata to the holders of allowed general unsecured Claims on account of all allowed general unsecured Claims⁵ (collectively, “Class 5 Claims”) until such Claims are paid in full without interest, costs or fees. Under no circumstances shall the Receiver be permitted to make any distributions on account to any of the Receivership Entities or any distributions to the owners of the Receivership Entities.

The Receiver has considered various distribution priorities, and after due deliberation, has determined that the Distribution Protocol is the most fair and equitable method to distribute the assets of the Receivership Entities.

Generally, in receivership proceedings related to securities fraud, courts have found that giving priority to the claims of fraud victims for amounts actually paid into a Ponzi scheme over holders of general unsecured Claims to proceeds traceable to the fraud is fair and reasonable because the funds paid out to victims are the funds they paid into the scheme. See Quilling v. Trade Partners, Inc., No. 1:03-CV-236, 2006 WL 3694629 (W.D. Mich. 2006). Indeed, in instances where the source of the funds to be used to repay creditors in a receivership are derived almost exclusively from the prior investments made by the investors in the Ponzi scheme, courts have recognized that preferring the investors in the fraud whose funds are the source of the assets being distributed is not only permissible, but even

⁵ The Receiver considers general unsecured Claims as Trade Creditors, Independent Contractors, Claims of Directors, Officers and Employees, and Claims asserted in the “Other” category.

preferred to treating all creditors *pari passu*. Id.; Clark, Ralph Ewing, A TREATISE ON THE LAW AND PRACTICE OF RECEIVERS §§ 637, 667 (3d ed. 1959) (setting forth a list of priorities where victim investors receive higher priority than general unsecured creditors); S.E.C. v. HKW Trading LLC, No. 8:05-cv-1076-T-24-TBM, 2009 WL 2499146 (M.D. Fla. 2009) (In determining whether a claimant was entitled to payment as an administrative expense claim, the court stated that “[p]ayment to claimants whose property was unlawfully taken from them is given a higher priority than payment to the general creditors.”); see also U.S. Commodity Futures Trading Com’n v. Capitalstreet Fin., LLC, No. 3:09cv387-RJC-DCK, 2010 WL 2131852 (W.D.N.C. 2010) (approving a distribution and priority scheme that paid claims in the following order: (1) first, to claims for the actual costs and expenses of administration of the receivership estate; (2) second, to the return of investments made by the victim investors in the scheme; and (3) finally, to any general creditors (should any assets remain in the estate)); Bank Wis., N.A. v. Malachi Corp., 245 F. App’x 488, 495 (6th Cir. 2007) (affirming partial distribution to one group of unsecured creditors before another group of unsecured creditors); CFTC v. PrivateFX Global One, 778 F. Supp 2d 775, 786 (S.D. Tex 2011) (court approved distribution scheme that subordinated unsecured claims to the claims of the defrauded investor claims for amounts such investors invested). The basis for prioritizing the investor victims of the fraud over that of general unsecured Claims is that the funds to be distributed by the receivership estate are directly derived from the funds provided to the Receivership Defendant by these investors. Quilling v. Trade Partners, Inc., No. 1:03-CV-236, 2006 WL 3694629 (W.D. Mich. 2006).

As detailed in the factual background above and the SEC Complaint, the Receivership Entities generated little legitimate investment returns revenue over the course of its existence. Instead, the large majority of the “investment returns” reported were proceeds of the Investors’ payments into the Ponzi scheme. The facts in this case make it clear that the assets collected by the Receiver for distribution are

the proceeds of the payments made by Investors to the Receivership Entities in the Ponzi scheme – the Class 3 Claims.

Because the Ponzi scheme was funded almost exclusively by the Investors, and the funds provided by the Investors are the assets that the Receiver has largely recovered, the Receiver believes that the Distribution Protocol is fair and reasonable in this case. As set forth above, the Distribution Protocol prioritizes the Investors' Claims for funds paid to the Receivership Entities (*i.e.*, the Class 3 Claims) to all other Claims except allowed secured Claims (allowed Class 2 Claims and in that instance, solely with respect to payments made from the direct proceeds of such Claimant's collateral) and those allowed Claims for the actual and necessary costs and expenses incurred by the Receiver and the Receivership Team subsequent to the appointment of the Receiver (the Class 1 Claims, which are the costs incurred for preserving, liquidating and distributing the assets to the Claimants). The Receiver believes that the Distribution Protocol is fair and reasonable and requests that the Court approve the Distribution Protocol.

Additionally, if this Court approves the Distribution Protocol, the Receiver hereby requests that he be permitted to maintain the Claims data filed in regard to Class 4 and Class 5 Claims, if any, but not be required to reconcile such Claims, unless and until the Receiver determines that, subject to adequate reserves, there are adequate assets to pay the Claims in Classes 1, 2 and 3 in full. Requiring the Receiver to reconcile Claims that he will not have sufficient assets to pay will create increased expenses and provide no value to the Estate or the holders of Claims.

C. Calculation of Distributions on Account of Allowed Claims

If this Court approves the Distribution Protocol, the Receiver believes he has sufficient assets to pay all Class 1 Claims and Class 2 Claims (to the extent any Class 2 Claims exist) in full as and when such Claims become due. Subsequent to the payment in full of holders of allowed Claims in Classes 1

and 2, the Receiver will begin to make distributions on account of allowed Class 3 Claims on a pro-rata basis, subject to the requirements set forth herein. The Receiver's proposed methodology for making distributions for Class 3 Claims is described below.

1. Rising Tide Distribution Methodology

In order to make distributions on account of allowed Class 3 Claims, the Receiver has determined that the "rising tide" method of determining distributions is the most fair and reasonable manner to make distributions in this Case.

In general, there are two methods of making distributions in Ponzi scheme cases that have been favored, the "net loss" (sometimes referred to as "net investment") method of establishing amounts to be distributed, and the "rising tide" method. SEC v. Huber, 702 F. 3d 903, 905-06 (7th Cir. 2012); see also U.S. Commodity Futures Trading Com'n v. Barki, LLC, No. 3:09 CV 106-MU, 2009 WL 3839389 (W.D.N.C. Nov. 12, 2009) (in selecting the "net investment" method, this Court noted that there are at least five methods for making distributions in receivership cases).

Under the "net loss" distribution methodology, a receiver seeks to distribute funds to claimants who hold allowed claims arising from investing in the fraud on a pro-rata basis, based on the net remaining loss the claimant was owed by the entity in the receivership on the date that the receivership commenced. In sum, the "net loss" methodology ignores how much the entity in receivership distributed to the creditor in the past (assuming the creditor has not received more than such creditor invested), and, instead, focuses solely on the amount of the net loss of the creditor remaining on the date the receivership commences. Creditors then receive distributions on a pro-rata basis on account of their remaining net loss.

The "rising tide" distribution methodology seeks to make distributions based on the gross amount paid to the entity in receivership by a claimant (essentially treating that amount as such claimant's gross

claim), and treats each payment to the claimant over the life of the relationship with such entity as a distribution on account of that gross claim. Thus, using this method, the receiver will only make a distribution to a claimant in an instance where the overall aggregate amount the receiver has to distribute to claimants on a pro-rata basis is more than the amount such claimant has been distributed in the past. To determine the amount the claimant will receive, the receiver will compute the pro-rata amount such claimant would be paid absent any deductions on account of prior distributions and subtract the amount of such prior distributions. If that difference is positive, the Receiver will pay such claimant based on the amount of that difference, subject to the distribution procedures. If that amount is negative or zero, the claimant will not receive any distribution.

To illustrate both methodologies, the Seventh Circuit provided the following examples:

To understand the difference between the two methods, imagine that three investors lose money in a Ponzi scheme. A invested \$150,000 and withdrew \$60,000 before the scheme collapsed, so his net loss was \$90,000. B invested \$150,000 but withdrew only \$30,000; his net loss was \$120,000. C invested \$150,000 and withdrew nothing, so lost \$150,000. Suppose the receiver gets hold of \$60,000 in assets of the Ponzi scheme - one-sixth of the total loss of \$360,000 incurred by the three investors (\$90,000 + \$120,000 + \$150,000). We'll call these recovered assets "receivership assets." Under the net loss method each investor would receive a sixth of his loss, so A would receive \$15,000, B \$20,000, and C \$25,000[.]...

Under the rising tide method, withdrawals are considered part of the distribution received by an investor and so are subtracted from the amount of the receivership assets to which he would be entitled had there been no withdrawals. (When there are no withdrawals, rising tide yields the same distribution of receivership assets as net loss.) In our example, the total of withdrawn plus receivership assets is \$150,000 (\$60,000 + \$30,000 + \$0 [the withdrawals] + \$60,000 [the receivership assets]), but there is only the \$60,000 in such assets to distribute. A, having been deemed (as a consequence of the rising tide approach) to have "recovered" \$60,000 before the collapse of the Ponzi scheme, is entitled to nothing from the receiver, as otherwise the remaining sum of withdrawals and receivership assets - a total of \$90,000 (\$30,000 in withdrawals, all by B, and \$60,000 in receivership assets) - would be insufficient to bring the remaining investors up to anywhere near A's level. For remember that under the net loss method each investor would have received the same fraction of receivership assets as his fraction of the loss, and thus A

would have received \$15,000, B \$20,000, and C \$25,000. The result, since under the rising tide method withdrawals are treated as compensation, is that A would have been “compensated” to the tune of \$75,000 (\$60,000 withdrawn + \$15,000 in receiver assets), B \$50,000 (\$30,000 + \$20,000), and C \$25,000 (the balance of receiver assets, C having had no withdrawals).

For the “tide” to raise B and C as close to A as possible, B has to receive \$15,000 in receiver assets, for a total “recovery” of \$45,000, and C the remaining receiver assets, giving him \$45,000 too. The division of withdrawals plus receiver assets is then 60–45–45, as shown in the next chart, versus 75–50–25 under the net loss method.

SEC v. Huber, 702 F. 3d at 906.

The rising tide method is the method most commonly used (and judicially approved) for apportioning receivership assets. Id. (collecting cases). This method provides the most parity to victims of a fraud because investors who have received a return of portions of their principal investment from the entity in receivership will not receive further distributions of principal until all other claimants with allowed claims have received an equal percentage of their principal (or more because the “tide” has not yet reached its allowed claim). In sum, the “rising tide” method seeks to provide the same recovery to all victims who invested money in the scheme regardless if it came from the entity in receivership prior to or after the collapse of the scheme.

According to the SEC Complaint, this Ponzi scheme operated for several years. In that time, there were numerous investors who received payments from the Receivership Entities, but far more who did not. Based on the Receivership Team’s review it is apparent that very few of the investors actually received the principal amount of their investment back from the Receivership Entities. As such, the majority of Claimants who hold allowed Claims have no “tide” to meet - they will receive distributions without the need to account for any prior “distributions” made by the Receivership Defendant. However, some Claimants received payments from the Receivership Defendant before the collapse of the scheme. Paying such entities on account of the small percentage of their original principal payment that has not

been repaid is inequitable to those investors that never received any return of their “investment”. The Receiver, therefore, believes that the fairest and most equitable method for calculating distributions to be made is the “rising tide” method.

In Barki, this Court examined the various methodologies and determined that the “net loss” method was the most equitable method for making distributions in that case. U.S. Commodity Futures Trading Com’n v. Barki, LLC, No. 3:09 CV 106-MU, 2009 WL 3839389 (W.D.N.C. 2009). The facts in that case, however, are vastly different than those in this case. In Barki, there were 79 individuals who invested in the fraudulent scheme and using the rising tide method of distributions in that case would have excluded more than half of the victims of the scheme from receiving distributions. Id. The Court, therefore, found that the distribution method that was the most equitable in that case was the “net investment” method. Id. However, in contrast to the Barki case, more than 150 Claims were filed in this Case and the vast majority of the Investors will be eligible to receive distributions in this Case using the rising tide methodology. As such, the Receiver contends that the “rising tide” method is the most equitable method of distribution in this Case.

2. Establishing Distribution Reserves

Upon this Court approving the methodology for distributions, the Receiver will recommend an interim distribution to holders of Claims that have been reconciled and allowed as quickly as possible. However, in order to do so, the Receiver will be required to establish reserves to ensure that the Receiver does not distribute funds such that if a Claim is allowed, insufficient funds would be left to pay such Claim. Such reserves will be released by the Receiver to make appropriate distributions to the holder of the Claim (if the Claim is allowed), or to the pool of assets to be distributed to all holders of allowed Claims upon the entry of an order that has become final by this Court or an appellate court of competent jurisdiction. In the course of establishing the amount of those reserves, the Receiver will be required to

reserve against the possibility of being required to make distributions on all Claims as if they were allowed in the full amount that such Claim was filed, not the amount the Receiver believes should be allowed for the Claim. Establishing such reserves will undoubtedly decrease the amount of funds that are available to be distributed to holders of Claims on an interim basis. This is a necessary step in order to provide an interim distribution, however, and as Claims are reconciled, the Receiver will be able to release reserves not needed to provide distributions on account of the Claims for which the reserve was established.

D. Distribution Procedures

1. Collection of Certain Data to be Eligible to Receive Distributions

The Receiver has determined that, pursuant to applicable law, he is required to obtain certain information from holders of allowed Claims in order to make distributions to such holders.

Based on the Receivership Team's analysis, the Receiver has determined that he is required to collect certain tax information in order to make distributions pursuant to certain regulations of the Internal Revenue Service (the "IRS") or be required to utilize the Court-approved financial advisor to maintain and collect backup withholdings for each individual or entity that receives a distribution. This would create a costly and time consuming administrative process that provides no benefit to the Estate and would reduce the distributions that could be paid to all holders of allowed Claims. Therefore, in order to receive a distribution, the Receiver hereby requests that this Court require the holder of an allowed Claim to submit either a W-9 form, if the holder is treated as a United States entity or citizen by the IRS, or a W-8 form, if the holder is treated as a non-U.S. entity or citizen by the IRS (although the Receiver does not believe any holder of Claims is a non-U.S. entity or citizen. The proposed treatment of the distribution that is allocated to an allowed Claim holder that fails to submit a W-9 form or a W-8 form is set forth in more detail below. If approved by this Court, the Receiver would also request that the submission of a

W-9 or W-8 also serve as conclusive evidence that the submitting Claimant agrees that it has released any and all claims that it has or may have, if any, against the Receiver or the Receivership Estate. However, the failure to submit a W-9 or W-8 form would be treated as the waiver of a holder of an allowed claim to any distribution by the Receiver or Receivership Estate.

The Receivership Team will collect the W-9 forms from each approved Claimant. The Receiver may elect to also establish a web-based process to collect electronic W-9 submissions so long as such electronic collection can be done in a manner that is in accordance with the regulations set forth by the IRS for electronic submission of W-9 forms. However, even if the Receiver establishes a web-based W-9 submission platform, approved Claimants will still be permitted to submit paper copies of W-9 forms in the same manner in which they submitted a Claim.⁶

2. The Making of Distributions

In order to provide for orderly and cost effective distributions, the Receiver hereby requests that this Court approve the following procedures for making distributions to all holders of allowed Claims.

(a) *Delivery of Distributions in General.* The Receiver shall make distributions solely to the holders of allowed Claims without regard to any Claim or interest asserted by any third party in such distributions. Distributions shall be made to the holders of allowed Claims at the addresses set forth in the Claims asserted by such holders, as amended by such holder on the Claims.

(b) *Payments.* Distributions shall be made to all holders of allowed Claims by checks drawn in United States dollars on a United States domestic bank. The Receiver evaluated many potential methods of making distributions in this case and has determined that the issuance of checks is the only reliable

⁶ Due to certain regulations of the IRS and what is likely to be a prohibitive cost, collection of W-8 forms via a web-based platform is likely not possible. The Receiver will provide a W-8 web-based platform if he is able to do so in a cost-effective manner that complies with applicable regulations or is approved by the IRS. If not permissible or is not cost effective, the Receiver will require that W-8 forms be submitted to the Receiver through the submission of a W-8 form via conventional mail.

manner that will provide the Receiver with the ability to comply with applicable law and the Applicable Regulations.

(c) *Interest on Claims.* Interest shall not accrue or be paid on any Claim, and no holder of a Claim shall be entitled to interest accruing on any Claim. Interest shall not accrue or be paid upon any Claim in respect of the period from the date the Receiver was appointed to the date this Case is closed.

(d) *No de Minimis Distributions.* The Receiver shall not be required to make a distribution to the holder of an allowed Claim if such distribution is an amount of less than \$100.00. The Receiver has determined that the cost involved in making distributions in amounts of less than \$100.00 would not be cost effective. Any holder of an allowed Claim that does not receive a distribution solely because of this provision will have such distribution reserved until such time as the holder would receive a distribution in the amount of \$100.00 or more.

(e) *Forfeited Distributions.* The holder of a Claim that fails to provide, within 180 days of the Claim Determination becoming final, a (i) Release, (ii) W-9 form or W-8 form (as applicable), or (iii) an OFAC Certificate, shall be deemed to have forfeited any distribution to which they would otherwise be entitled (a “Forfeited Distribution”). Forfeited Distributions shall be deemed forfeited on the 181st day subsequent to such Claimant’s Claim Determination becoming final.

(f) *Unclaimed and Undeliverable Distributions.*

i. “Unclaimed Property” shall mean distributions (1) that are Forfeited Distributions; (2) that are returned to the Receiver as undeliverable and no appropriate forwarding address is received within 90 days after such attempted distribution by the Receiver is made to such holder; (3) for which the check making such distribution is not negotiated within 180 days of its issuance and no request for re-issuance is made within such 180 day period, at which time, such distribution shall be cancelled through

a stop payment order or other means; or (4) remaining after the Final Distribution. The Receiver is under no affirmative obligation to attempt to locate any holder of an allowed Claim.

ii. If the combined total of Unclaimed Property related to allowed Claims totals (1) \$25,000 or more, the Unclaimed Property shall, subject to Section (e) (“No de Minimis Distributions”) and other relief approved by this Court in this Motion, be redistributed to the other holders of allowed Claims in Class 3 until the holders of allowed Claims in Class 3 are paid in full on account of their allowed Claims in Class 3, and, thereafter, distributed by the Receiver to other holders of Claims allowed in the order of priority established by this Court, or (2) if less than \$25,000, the Unclaimed Property shall be donated to a non-denominational charity to be selected at a later date; provided that, all Claims in respect of the Unclaimed Property shall be deemed disallowed, and the holder or successor to such holder of any Claim so disallowed will be forever barred, expunged, estopped and enjoined from asserting any such disallowed Claim in any manner against the Receiver, the Estate, or their respective property, notwithstanding any federal or state escheat laws to the contrary.

(g) *Interim Distributions.* The Receiver, in his discretion, may make interim distributions to the holders of allowed Claims entitled thereto in accordance with the procedures contained herein.

(h) *Final Distribution.* The Receiver shall make a final distribution to holders of allowed Claims entitled thereto in accordance with the procedures contained herein. Such final distribution shall provide for the distribution of as much of the Estate’s assets as is possible without causing a disparity in the pro-rata distribution to be made on allowed Claims. Any remaining Estate Assets shall be treated as Unclaimed Property. Upon making the final distribution, the Receiver shall file a report with this Court.

(i) *Reserves for Claims not Yet Allowed.* For the purpose of making interim distributions, the Receiver shall establish, in his discretion and without further order of this Court, reserves for all Claims

that have not been disallowed (whether pursuant to section D(2)(f) of these procedures or in the Claim reconciliation process).

(j) *Compliance with Tax Requirements.* In connection with the distributions made in accordance hereto, to the extent applicable, the Receiver shall comply with all tax withholding and reporting requirements imposed by any governmental unit and all distributions shall be subject to such withholding and reporting requirements. The Receiver shall be authorized to take any and all actions that may be necessary or appropriate to comply with such withholding and reporting requirements.

(k) *Compliance with Court Orders and Applicable Regulations.* If an entity is not permitted to receive a distribution or is required to forfeit any distribution because of any court Order or Applicable Regulation, the Receiver requests that he be able to retain such distribution and treat such distribution as if it were Unclaimed Property unless required to treat such distribution differently by applicable United States law. The Receiver requests that this Court find that he will have no liability to any holder of a Claim whose distribution is treated as Unclaimed Property because the Receiver has acted in accordance with what he believes to be a valid court Order or an Applicable Regulation.

The Receiver believes that in light of the circumstances of this Case, the above procedures are fair, reasonable, and in the best interest of the Estate.

IV. CONCLUSION

WHEREFORE, the Receiver hereby requests that the Court enter an order authorizing (1) the procedures for the resolution of certain matters arising in regard to the reconciliation of Claims, including, but not limited to, granting the Receiver authority to settle Claims asserted against the Receivership Entities, establishing a procedure for settling Claims filed against the Receivership Defendant, and establishing the method by which either party may appeal an adverse determination of the Receiver to

this Court; (2) the establishment of the priority of allowed Claims for making distributions to the holders of allowed Claims; (3) the establishment of the rising tide methodology for determining the distributions to be made on account of the allowed Claims held by Investors; (4) the procedures for the collection of necessary information to make distributions to holders of allowed claims, and the establishment of the procedures for making distributions; and (5) for such further relief as this Court deems just and proper.

This 19th day of May, 2018.

Respectfully submitted,

/s/ Stephen F. Del Sesto
Stephen F. Del Sesto, Esq. (Bar #6336)
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Wealth Management, LLC, ClearPath
Multi-Strategy Fund I, L.P., ClearPath
Multi-Strategy Fund II, L.P., and ClearPath Multi-
Strategy Fund III, L.P. and not individually*
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CERTIFICATE OF SERVICE

I, Stephen F. Del Sesto, hereby certify that I filed the within document on the 21st day of May, 2018, and that notice will be sent electronically to all counsel who are registered participants identified on the Mailing Information for Case No. 15-cv-00191-S-LDA.

/s/ Stephen F. Del Sesto